



Tencent vs. Alibaba: Why matter and who wins?

5 April, 2016

INVESTMENT SUMMARY

- We initiate Tencent with a BUY rating and a TP of HK\$187 because we believe Tencent has an upper hand in the competition against Alibaba (BABA US, BUY, TP: US\$84) to be the top Internet ecosystem in China;
- Weixin has given Tencent three mandates, in our view: (1) a mobile display interface, (2) an online-to-offline bridge and (3) a closed loop business platform. We believe the impact will result in great expansion of Tencent's business scope;
- In the near term, we expect conversion of PC-based e-sports game to mobile, and rolling out of Weixin advertising to drive growth. We project top line growth of 39% and 26% and non-GAAP operating profit growth of 34% and 25% in 2016/17.

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Tencent Holdings Limited (SEHK: 700)

Realistic imaginations: Initiate with BUY

- Despite being at the interlude of its growth phases, we believe Tencent's grasp of the mobile Internet ecosystem warrants a BUY.
- The potential of Weixin as an ecosystem orchestrator is still at the early stage. China's entertainment spending per GDP still has big room to improve.
- Catalyst: Weixin Moments ads, eSports game conversion, mobile MMOG.

Tencent is between growth phases

Unlike in previous situations when Tencent's share price was under pressure when business was under transition, this time Tencent's mastery of mobile Internet ecosystem keeps its share price high. We believe this will continue.

Clear growth catalyst in 2016, less so in 2017

We expect mobile MMOG to sustain Tencent's online game growth at 28% YoY in 2016, leaving the conversion of PC-based eSports games to mobile to sustain growth of 20% YoY in 2017. We expect the launch of Weixin Moments Ads to drive Tencent's advertising growth at 66% YoY in '16. However, in '17 we expect advertising growth to grow to 31% YoY. New monetization must kick in.

TenPay and AliPay can both win

Tencent's next growth opportunity lies in the deepening of e-commerce penetration to broader categories of retail, mostly offline. To that end Tencent has built an alliance network around Weixin/QQ. We expect TenPay and AliPay together to take market share from offline and TenPay to take share from AliPay.

Valuation is reasonable, initiate with BUY, TP=HK\$187

Tencent is trading at 31x 2016E which is at the historical mid-range of its PE multiples. This valuation is not demanding in our view. Potential risks include game aging, e-sports game conversion below market expectation and advertising inventory saturation. Our 2016-17 top line estimates are 5.6% and 5.2% above consensus.

Summary financial data

Highlights	F2013A	F2014A	F2015A	F2016E	F2017E	F2018E
Revenues (Rmb mn)	60,436	78,932	102,863	142,467	178,901	216,706
Non-GAAP operating profit (Rmb mn)	18,760	28,604	39,339	53,072	66,289	80,226
Non-GAAP EPS (Rmb)	1.85	2.81	3.41	4.27	5.44	6.58
GAAP EPS (Rmb)	1.66	2.54	3.10	3.83	4.89	6.01
EBITDA margin	37%	42%	45%	43%	44%	44%
P/E (non-GAAP)	71.9	47.3	39.0	31.1	24.4	20.2
Free cash flow yield (%)	1.3%	3.5%	1.3%	0.8%	6.8%	1.4%
Dividend yield (%)	9.5%	7.4%	9.1%	9.0%	9.0%	9.0%

Source: BLRI, CapitalIQ, Tencent (as of 4/1/2016)

BUY

HOLD

SELL

Target Price: HK\$ 187	Current Price: 158.50
RIC: (SEHK:700)	BBG: 700:HK
Market cap (US\$ mn)	186,069
Average daily volume (US\$ mn)	4,722
Shares out/float (m)	9,309.0/16,446.5

Source: CapitalIQ (as of 4/1/2016)

Key Changes

	New	Old	Diff
BLRI Recommendation	BUY	-	-
BLRI Target Price (HK\$)	187	-	-
2016E EPS (Rmb)	4.27	-	-
2017E EPS (Rmb)	5.44	-	-
2018E EPS (Rmb)	6.58	-	-

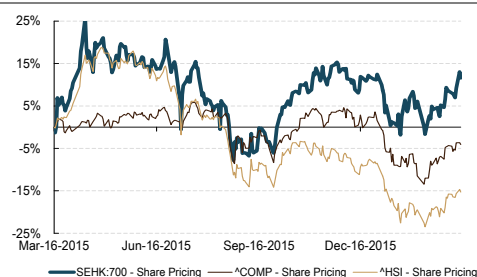
Source: BLRI, non-GAAP (as of 4/1/2016)

BLRI vs. The Street

No. of CapitalIQ Recommendations	33
Target price vs. CapitalIQ mean	20%
1-year-fwd EPS vs. CapitalIQ mean	(4%)
CapitalIQ recommendation (1=BUY, 5=SELL)	1.43

Source: BLRI, CapitalIQ (as of 4/1/2016)

Price performance and volume data



Source: CapitalIQ (as of 4/1/2016)

Research team



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Blue Lotus Capital Advisors Limited

All prices are those current at the end of the previous trading session unless otherwise indicated. Prices are sourced from local exchanges via Reuters, Bloomberg and other vendors. Data is sourced from CapitalIQ, Blue lotus capital advisors Limited and subject companies. Consensus forward estimates are used in analysis. Past performance is not indicative of future results. Investors should consider this report as only a single factor in making their investment decision.

Tencent Holdings Limited: Financial Summary

Fiscal year-ends December 31

Exhibit 1. Income statement

	F2014A	F2015A	F2016E
Revenues	78,932	102,863	142,467
Cost of revenues	(30,873)	(41,631)	(61,114)
Gross profit	48,059	61,232	81,354
G&A cost	(14,155)	(16,825)	(21,903)
Marketing cost	(7,797)	(7,993)	(10,558)
Operating profit GAAP	26,107	36,414	48,893
Share based compensation	(2,497)	(2,925)	(4,179)
Operating profit non-GAAP	28,604	39,339	53,072
Finance cost/income	(1,182)	(1,750)	(2,135)
Other income/cost	4,435	4,213	4,219
Share of (losses)/profits of associates and JVs	(347)	(2,342)	(5,203)
Pre-tax profit, GAAP	29,013	36,535	45,774
Income tax	(5,125)	(7,013)	(9,155)
Net income, GAAP	23,888	29,522	36,619
Net income, non-GAAP	26,385	32,447	40,798
Non-controlling interests	78	410	596
Number of shares, diluted	9,357	9,399	9,407
EPS, GAAP	2.54	3.10	3.83
EPS, non-GAAP	2.81	3.41	4.27
Gross margin	61%	60%	57%
Operating margin, non-GAAP	36%	38%	37%

Source: BLRI, Tencent (as of 4/1/2016)

Exhibit 2. Balance sheet

	F2014A	F2015A	F2016E
Cash and cash equivalent	42,713	43,438	32,632
Restricted cash and ST investmt.	9,174	54,731	65,677
Term deposits over three months	10,798	37,331	44,797
Accounts receivable	4,588	7,061	9,073
Prepayments and others	7,804	11,397	16,790
Inventory	244	222	0
Total current asset	75,321	155,378	168,969
Property and equipment	7,918	9,973	21,275
Construction in progress	3,830	4,248	2,124
Investment in a JCE	54,135	66,945	70,292
Intangibles, goodwill and others	9,304	13,439	13,882
Available-for-sale financial assets	13,277	44,339	48,773
Total non-current assets	95,845	151,440	170,125
Total assets	171,166	306,818	339,094
Account payables	8,683	15,700	20,094
Accrued expense and others	21,984	76,155	62,994
Deferred revenues	16,153	21,122	21,033
Short term debt	3,215	11,429	12,000
Total current liabilities	50,035	124,406	116,121
Long term debt	30,535	50,014	46,294
Other Long-term liability	8,472	10,298	10,298
Total non-current liability	39,007	60,312	56,592
Total equity	80,013	120,035	164,316
Total liabilities and equity	171,166	306,818	339,094

Source: BLRI, Tencent (as of 4/1/2016)

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 42% market share in 2015. We expect it to grow across 50% by 2019. Its other revenues include advertising and e-commerce.

Industry View

We expect China's online game market to grow 21% and 15% YoY in 2016-17, of which PC and mobile will grow 3%, 2% YoY and mobile will grow 50% and 30% YoY, respectively. We expect China's Internet advertising market to grow 31% and 26% YoY in 2016-17, of which social ads will grow 80%, 60% and video ads 50%, 30% YoY, respectively.

Exhibit 3. Cash flow statement

	F2014A	F2015A	F2016E
Net income	23,888	29,522	36,619
Adjusted for			
Depreciation & amortization	4,801	6,629	8,868
Taxation	5,125	7,013	9,155
Net Interest	(494)	(577)	(296)
Changes in			
Account receivable	(1,633)	(2,473)	(2,012)
Inventory	1,140	22	222
Account payables	2,003	7,017	4,394
Short term deposit	3,782	(72,090)	(18,412)
Other asset	0	0	0
Accrued liabilities and deferred revenues	13,189	56,045	(9,364)
Cash from operations	53,360	29,968	29,157
Capex, PPE	(4,718)	(7,709)	(9,973)
Capex, land and bldg.	120	(1,542)	0
Purchase of intangibles	(7,242)	(5,143)	(7,123)
(Increase)/decrease in term deposits	6,589	1,157	(735)
Cash paid for equity investment	(762)	(31,062)	(4,434)
Payment for business combinations	(1,911)	(1,109)	(3,562)
Cash from investing	(6,248)	(43,081)	(23,395)
Cash from financing	19,170	24,850	(7,706)
Change in cash	61,651	5,301	(10,803)
Cash at beginning	20,228	42,713	43,438
Cash at end	42,713	43,438	32,632

Source: BLRI, Tencent (as of 4/1/2016)

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Recent Reports

Alibaba (BABA US, BUY, TP:US\$84):
Pessimism overdone, Upgrade to BUY,
January 27, 2016

JD.com (JD US, BUY, TP:US\$40):
Entering its time, initiating with BUY,
TP: US\$40, November 9, 2015

Alibaba (BABA US, HOLD, TP: US\$84):
Opportunities and challenge: Which is
greater? Initiate with HOLD, TP:
US\$84, October 26, 2015

Investment Cases at a Glance

Why is it a Buy

- **Weixin ecosystem is still at its early stage.** Despite being five years on the market, we believe Weixin's value to Tencent is still at its early stage. We summarize this value in three dimensions:
 - Weixin as a mobile browser: Like in PC, user habit on mobile will eventually migrate from app (client) to web (browser). This time mega app like Weixin acts as the browser. From the beginning Weixin has departed from other mobile IM apps (WhatsApp, LINE, etc.) in its intention to build an all-inclusive browsing environment. This effort has yet to bear fruit;
 - Weixin as an O2O bridge: Tencent has made extensive investments in various areas of O2O and sharing economy. These investments have been well received, thanks to Tencent's value provided to its partners comparing to Alibaba (BABA US, BUY, TP: US\$84). These investments have yet to contribute tangible and meaningful values;
 - Weixin+mobile QQ: Comparing to PC, Tencent now has a double-lock on an expanded demographic market in China. This made Tencent's traffic dominance more secure and monetization effort more versatile and more likely to succeed;
- Online entertainment industry is still at its early stage: Despite occupying 42% of China's online game market, Tencent's role in the broader entertainment industry can still expand with entertainment content expanding to new hardware platforms (screen to TV to console to PC to mobile to VR/AR) and a more balance revenue mix between game, movie, drama, literature and animation. China's entertainment budget is still low comparing to global standards;
- Advertising provides medium term growth driver: Tencent is making a comprehensive shift in business model from Freemium to Advertising. This shift also marks Tencent's growth strategy from direct monetization to building an ecosystem. This, in turn, should warrant a higher earnings multiple, in our view;
- E-sports title turned mobile game provides near term growth driver: Major PC game IP's have seen remarkable successes when converting to mobile. We expect Tencent's E-sports/ARPG blockbusters like *League of Legends* (LOL), *Crossfire* (CF) and *Dungeons & Fighters* (DNF) to achieve similar kind of successes, hereby supporting Tencent's near term revenue/profit growth. Despite difficulties to replicate the PC experience on mobile, we believe Tencent has time to do the games right.

What are the key catalysts for the next 3-6 months

- Success in e-sports/ARPG game conversion to mobile: CF already succeed after initial launch of Android version in September, 2015. For LOL, Tencent launched its in-house developed MOBA game *King's Honour* (王者荣耀) in November,

2015. According to Nexon, it will launch *DNF* Mobile version (official) in China in 2016 with Tencent;

- Weixin Moments advertising will be back loaded in 2016: Tencent opened up competitive bidding in 1Q16, we expect revenues to step up in 2Q16 and grow exponentially in 2H16. We expect Weixin Moments Ads to contribute Rmb6.1bn and 8.7bn in revenues in 2016-17, up from Rmb900mn in 2015 and nil in 2014.

Where can we be wrong?

- E-sports games can disappoint in revenues when converting from PC (-): There has been controversies in the industry on suitability to convert PC e-sports games to mobile. *CF* successfully pointed to the possibility, but it might be because Tencent controlled *CF*'s development and pace. If *DNF* fails it could reduce Tencent's revenue potential;
- Cannibalization of Weixin Moments ads to mobile Qzone ads (GDT, 广点通) (-): We believe Weixin and mobile QQ/Qzone target different demographics in profile. But if Tencent fails to expand its advertiser base, cannibalization can occur. We estimate GDT will achieve Rmb9.9bn and 11.1bn in revenues in 2016-17, up from Rmb7.8bn and 3.2bn in 2015 and 2014. Apparently GDT growth has run into a bottleneck;
- Globalization achieves tangible results (+): Weixin's performance overseas has been lacklustre because Tencent does not command as comprehensive an ecosystem overseas as it does domestically. But this could change if Tencent achieves sufficient market share in particular area of applications.

Operating Metrics

Exhibit 4. Quarterly financial table

(Rmb mn)	1Q15A	2Q15A	3Q15A	4Q15A	1Q16E	2Q16E
Net revenues	22,399	23,429	26,594	30,441	32,000	34,198
Value added service	18,626	18,428	20,547	23,068	24,476	24,645
Online game	13,313	12,970	14,333	15,971	17,758	17,317
Social network	5,313	5,458	6,214	7,097	6,718	7,328
Advertising	2,724	4,073	4,938	5,733	5,556	7,191
Brand	1,362	2,016	2,552	2,817	2,536	3,071
Performance	1,362	2,057	2,386	2,916	3,020	4,120
Other revenues (e-commerce, payment, etc.)	1,049	928	1,109	1,640	1,968	2,362
Cost of revenues	(8,965)	(8,991)	(11,014)	(12,661)	(13,487)	(14,139)
Gross profit	13,434	14,438	15,580	17,780	18,513	20,060
Gross margin	60.0%	61.6%	58.6%	58.4%	57.9%	58.7%
Other operating income, net	932	1,210	1,173	898	1,094	1,055
Sales marketing	(1,326)	(1,601)	(2,042)	(3,024)	(1,766)	(2,176)
General Admin	(3,668)	(4,011)	(4,380)	(4,766)	(4,953)	(5,534)
Share-based compensation	(593)	(659)	(780)	(893)	(939)	(1,003)
Operating profit, non-GAAP	9,033	9,485	9,938	10,883	12,733	13,353
Operating margin, non-GAAP	40.3%	40.5%	37.4%	35.8%	39.8%	39.0%

Source: BLRI, Tencent (as of 4/1/2016)

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Tencent vs. Alibaba: Who wins?

With the exception of respective cash cow businesses of game and e-commerce, Tencent and Alibaba have been at war in almost every subsector of Chinese Internet. In the just concluded Chinese New Year, Alibaba mounted an attack on Tencent's Weixin Payment by giving away Rmb600mn of Red Packet (红包). Our questions are: Do they need to fight this war? If they do, who will win?

Does the war matter to Tencent and Alibaba's share prices?

We believe it does.

Tencent got into e-commerce via the investment (2010) and acquisition of 51BUY (2012). At 1Q12 PC client games contributed 55% of Tencent's total revenues according to our estimate and has clearly entered growth bottlenecks. Luckily, by 4Q13 mobile games arrived and in three short years has surpassed PC client games in market size. But mobile game has grown too fast too quickly. By 2017 we expect mobile game growth rate would have slowed to 30%. Tencent needs to look for growth headroom again. Even though over the long run we are optimistic about the potential of entertainment industry in China, an air pocket in growth could develop if the necessary technologies (like AR and VR) fail to emerge at the right time.

Historically, Tencent has always been vigilant to challenges that could upset its user and usage bases. Both the war against SINA Weibo (2010) and war against JD.com (2010, JD US, BUY, TP: US\$40) resulted in Tencent bowing out of the competition in 2013 and 2014, but only after both proving to be unthreatening. Starting also from 2012, Weixin grew exponentially and concluded Tencent's dominance in mobile Internet. Even though Tencent has become at ease in its competitive environment, Tencent realized the potential of Weixin can take Tencent far beyond its original root of digital entertainment. Tencent started to map its future.

Three Mandates have come for Weixin

The word of Mandate is often used to describe a defined destiny. We believe Weixin carries three such defined destinies. We call them *Display*, *Connect* and *Closed Loop*.

- **Display:** Weixin differs from WhatApps in that it is a mobile browser built in the Weixin shell. Besides the messaging function, Weixin can also display any output and be the human machine interface for any applications running on mobile. This opens up the room for **Advertising** and possibly app running. We estimate that like for like, the amount of time split between Weixin and app to be 1:4 or 1:5;
- **Connect:** Mobile Internet connects offline with online. Mobile is personal. Through these two characteristics Tencent's ability to connect people reached a new level. This takes the lid off for **Shared Economy** or **Local Services**;
- **Closed Loop:** Mobile Internet is the first kind of Internet that users do not need to leave the virtual world. Camera, NFC and Two Dimensional Code connect the offline while social network accounts and mobile browser connect the online. This closed loop integrates **Payment** and **E-commerce** with advertising and service rendering. The result is great expansion of Tencent's business scope.

To fully utilize Weixin's potential Tencent must touch Alibaba's cheeses. Tencent's conflict with Alibaba does not result from some knee jerk reaction to a perceived plot to overthrow Tencent's

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Tencent has been constantly worrying about online game market saturation.

Weixin has the potential to be both an OS (machine to human) and a social network (human to human).

dominance which could be put to rest when Tencent feels more assured. The motivation for Tencent to challenge Alibaba is a mixture of greed and fear, opportunity and crisis. Perhaps realizing Tencent's strategic intent, Alibaba proactively take an offensive against Tencent.

Tencent's traffic+ model has clear value add to partners

Although at early stages, Weixin has started to irradiate its strategic values. Its first step is to maximize the advertising value. By this we mean both selling advertising slots for revenue and directing traffic to worthy partners that can, in the long run, leading to more comprehensive ecosystem to enhance Tencent's competitive position. These partners are often chosen to maximize Weixin's future potential in the mandates of *Connect* and *Closed Loop*.

With Weixin, Tencent obtained, for the first time, access to all China's populations. Yes, Tencent has achieved traffic dominance through QQ on PC but its influence from QQ.com did not surpass SINA until 2009. For decades QQ stands for younger generations, lower income and blue collars. Tencent strategically set Mobile QQ apart from Weixin to maximize its market share coverage, using Mobile QQ to target the young, Quadratic Element (二次元) or ACGN (Animation-Comic-Game-Novel) generations while using Weixin for professionals and grown-ups.

Exhibit 5 below summarizes Tencent's major partnerships in mobile Internet. As we can see nine out of fourteen mobile Internet investments have to do with O2O (Online-to-Offline).

The Weixin+QQ combination now gives Tencent full access to all Chinese populations.

Tencent has cornered almost every segment of O2O, forging partnerships with Didi, Dianping/Meituan, 58.com, 3Daixi, 1jiajie and Eleme.

Exhibit 5. Major investments and partnerships in mobile Internet

Company name (English)	Company name (Chinese)	Date	Industry
Didi Taxi	滴滴打车	1/2014	Taxi hailing O2O
MGYun	刷机大师	1/2014	Mobile phone tools
Dianping	大众点评	3/2014	Group buying O2O
eHouse	易居	3/2014	Real estate O2O
NavInfo	四维图新	4/2014	Digital map
Whisper	Whisper	5/2014	Anonymous social
58.com	58同城	6/2014	Home service O2O
eDaixi	e袋洗	7/2014	Laundry O2O
1jiajie	e家洁	9/2014	Home service O2O
Kuaikan	快看	10/2014	Mobile social network
Heirloom	Heirloom	11/2014	Picture sharing
Renren Kuaidi	人人快递	11/2015	Crowd logistics
Eleme	饿了么	1/2015	Takeout delivery O2O
Dianping	大众点评	4/2015	Group buying O2O

Source: Data consolidated by BLRI (as of 4/1/2016)

How does Alibaba's strategy differ from Tencent's?

Unlike Tencent, Alibaba's investment and partner strategies lack clear exchange of value, in our opinion. It resembles more like strategy of Tencent before the arrival of Weixin.

From a top down perspective, Alibaba's strategies form four directions: (1) extension of existing businesses (Ant Financial); (2) leverage of existing competencies (AliCloud); (3) competitively motivated market entries in entertainment, hardware, online video and O2O; (4) blue sky fields (healthcare). As a result we saw Alibaba forming five clusters of businesses: (1) e-commerce business, (2) online banking business, (3) entertainment/hardware/cloud business, (4) cloud infrastructure business; (5) online healthcare business.

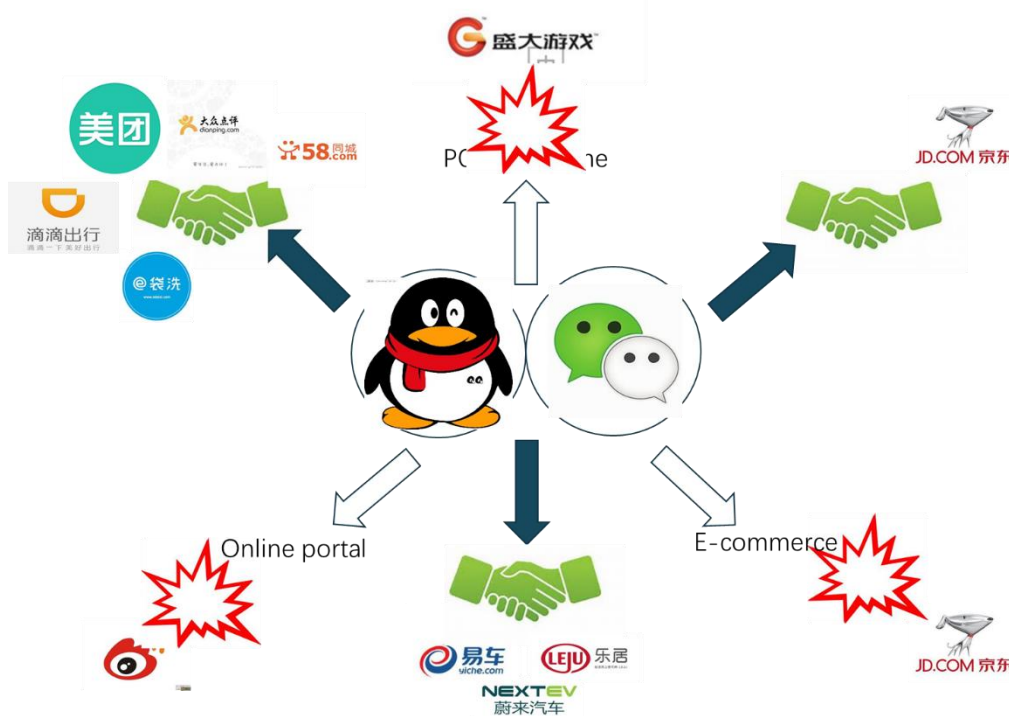
Tencent's strategy has changed from market entry to enabling. Can Alibaba compete against it?

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We believe Alibaba’s strategy resembles Tencent’s old strategy, which is to extend its business lines and competencies, leading to clash with other competitors like Shanda, JD.com and SINA. Now Tencent emphasizes on open collaboration with traffic users instead of fighting with them. Most partners that Tencent chose to work with are e-commerce companies, ranging from traditional, O2O to consumer durable e-commerce. These partnerships not only competes against Alibaba’s existing business, but also blocks Alibaba’s future growth headroom in e-commerce.

Tencent now uses its traffic to help its partners succeed, instead of leveraging traffic to compete against them.

Exhibit 6. Tencent’s old and new partnership strategy: from compete to enable



Source: BLRI (as of 4/1/2016)

The Tencent-JD alliance has a lot of unrealized potentials

Starting with a coincidence of events that led to Tencent investing in JD.com at its IPO, this alliance has increasingly proven its worth, in our view. Tencent’s traffic complements well with JD’s offline executions, riding on Chinese consumer’s upgrade in consumption to high quality and standardized goods. Since then Tencent has formed several similar partnerships with Didi Taxi, Meituan-Dianping, BitAuto, Leju and 58.com, as well as partners of these partners. These partnerships aren’t without strife as these partners fearing to rely on Tencent too much, but the alliances work well because of the division of labour, in our opinion.

Tencent-JD alliance is a good example of Tencent’s online+JD’s offline.

Decentralization and disintermediation of e-commerce is a trend

One theory that underpins the Tencent-JD alliance is the decentralization of e-commerce. But decentralization hasn’t done Tencent-JD any material good. In fact, JD closed down Paipai citing hardship in policing SME sellers. Weixin Commerce is also plagued by multi-level marketing schemes. JD’s own Weixin storefront initiative hasn’t generated any GMV either. Is decentralization real?

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Decentralization of e-commerce is real

Investors don't need to look any further than Alibaba CEO Daniel Zhang to look for proof of e-commerce decentralization. In the December 2015 Global Internet Conference in Wuzhen, Mr. Zhang promoted the idea of Web Red Economy (网红经济), or Web Red Economy, saying they are the fastest growing segment on Taobao's clothing category.

Before Web Red Economy, which mainly happens on Weibo, we witnessed the dramatically growth of Weixin Commerce (微商) in 2014. We estimate Weixin e-commerce had a GMV of Rmb 96bn in 2014. After a crackdown on multi-level marketing scheme in 2015, we estimate Weixin Commerce still grew 20-25%, thanks to Cyber Celebrities opening shop on Weixin.

The root of the Tencent-Alibaba conflict, in our view is the decentralization of e-commerce. Mobile Internet lowers the entry barrier of e-commerce for both e-commerce users and merchants, leading to drastic expansion of user base like mobile game has done to online gaming and smart phone has done to computing. These new merchants and users look for places to do business and most of them do not use e-commerce platforms, general or vertical. Mobile e-commerce relies on social media and social network to access to end users. If the payment function is enabled, merchants and users do not need to leave the social environment. The availability of fulfilment and payment provided by e-commerce platforms complete the service loop.

We should not overplay the importance of Web Red because in the physical world, the value chain is very long and involves physical transportation. As a result economy of scale will result. This differs from the virtual world, where storage and transport incur no cost. Nevertheless, the advent of O2O will transform retail, wholesale, production and procurement in our view, leading to the so called Industry 4.0 (for details please refer to our JD.com initiation on. Before this transformation fully plays out, online time spent is increasingly shifting to mobile and social, which means Weixin has two roles to play: (1) fundamentally change the structure of e-commerce by flattening, decentralizing and disintermediating it, (2) sell traffic that everyone wants. Both are happening.

Disintermediation endangers the search business model for mobile

Increasingly the function of PC search is not for finding information, but for the convenience of browsing. Users spend more time on mobile, which benefits search. But the enlarged demand from new ways of using mobile goes to apps and social networks/media because they can do things previously not thought to be doable. On PC, search is often the last step leading to transaction, hence it is closest to money. But in social networks/media users can access directly the merchant's store and pay. Intermediation is replaced by recommendation. From this point of view, decentralization of e-commerce is also disintermediation of e-commerce.

Social e-commerce changes the game on SME e-commerce

YY pioneered the practice of giving virtual gifts to cyber performers. It works because giving and receiving cyber gifts is very easy, thanks to the user education provided by online games. Now thanks to Taobao and Weixin stores, AliPay/TenPay/WeixinPay and 3P logistic providers, selling goods promoted by the show have also become relatively easy. A new kind of e-commerce, the so called Web Red Economics (网红经济) has risen.

Mobile Internet lowers the consumer entry barrier of using e-commerce. It also lowers the merchant entry barrier, creating a phenomenon called the Web Reds.

Tencent benefits from Weixin Commerce in both fundamental way and commercial way.

In mobile Internet, the function of search has switched to a function of browsing. Without displayable inventory, the value of search dissipates.

We believe Web Red Economics, as well as Weixin commerce before it, mainly addresses the C2C aspect of social e-commerce. C2C social commerce tries to fundamentally change the structure of e-commerce by decentralizing and disintermediating it. There is also a B2B2C aspect, which is behind the reason why Tencent collaborates with JD in a strategic initiative called “JT Plan” (京騰计划). It mainly sells the increasingly important social traffic to advertisers like JD.com.

Tencent and Alibaba are competing in two aspects of social e-commerce: C2C and B2B2C.

C2C social commerce happens when individual and SME merchants use their own talent to promote their product and services, leading to loss of revenues on the platform’s end. We believe these SME merchants have growth bottlenecks because offline elements of their business cannot scale as easily as online.

B2B2C social commerce happens when the platform inserts advertising into the social content. By this we often mean Native Ads (原生广告). A Native Ad is an advertising that is indistinguishable from the content itself (less tiny differences). For example, search is a Native Ads because paid advertising is displayed within or side by side with the search result (less tiny differences). News feed is a Native Ads because it mingles with readers’ reading habit. We believe Native Ad on social, or B2B2C social commerce is bigger than Web Red Economy in market size because it applies to both large corporations and SME’s.

Exhibit 7. The social e-commerce competition between Tencent and Alibaba



Source: BLRI (as of 4/1/2016)

In our JD.com initiation **Entering its time...Initiate with BUY, TP US\$40** (November 9, 2015), we estimate B2C/B2B2C has overtaken C2C in 2015 with B2C/B2B2C delivering GMV of Rmb2.0tn and C2C Rmb1.9tn. Within C2C we believe social e-commerce is taking a larger and larger portion of the pie.

Social network e-commerce (Weixin e-commerce) is still ~3x bigger than social media e-commerce (Web Red Economy).

In our view, there are two branches of C2C social e-commerce: one relies on social media, which is Web Red Economy; the other one relies on social network, which is Weixin Commerce (微商). In our Alibaba initiation **Challenge and Opportunity: Which side is bigger....Initiate with HOLD, TP US\$84** (October 26, 2015), we estimate Weixin Commerce was worth Rmb96bn in 2014, of which more than half is multi-level marketing (传销) for dubious cosmetics products. After Tencent cracked down on multi-level marketing in early 2015, we estimate Weixin

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Commerce still had 20-25% year-on-year growth, thanks to the rise of Web Red Economy, most of which has a Weixin store in addition to a Taobao store.

We estimate Web Red Economy (social media e-commerce) had a market size of Rmb30 bn in 2015 and we project it to grow to Rmb36 bn in 2016, and Rmb48 bn by 2019. We estimate the B2B2C aspect of social e-commerce had a market size of Rmb18 in 2015. We project it to grow to Rmb33 bn in 2016 and Rmb261n in 2019. Together we project the market of social e-commerce rose from 4.3% of online retail (excl. O2O online travel) in 2015 to 6.8% by 2019 (Exhibit 8).

We estimate Web Red Economy market size at Rmb30bn, or 1-2% of C2C e-commerce, but >10% of apparel C2C.

Exhibit 8. Social e-commerce market size estimate (Rmb bn)

(Rmb bn)	2014	2015	2016E	2017E	2018E	2019E
C2C social e-commerce	111	150	180	207	228	239
Social media commerce (Web Red Economy)	15	30	36	41	46	48
Social network commerce (Weixin e-commerce)	96	120	144	166	182	191
B2C/B2B2C social e-commerce	10	18	33	64	135	261
JD-Tencent	3.5	8.3	18	44	103	213
Tmall-Weibo	6.4	9.6	15	20	32	48
Total social e-commerce	121	168	213	271	363	500
Social e-commerce as % online retail (excl. O2O and travel)	4.3%	4.3%	4.3%	4.6%	5.4%	6.8%
Online retail	2,814	3,905	4,990	5,938	6,723	7,389
Total C2C	1,525	1,907	2,193	2,302	2,360	2,371
Total B2C/B2B2C	1,289	1,998	2,797	3,636	4,363	5,018

Source: BLRI, Tencent (as of 4/1/2016)

Exhibit 9. Web Red store at a glance

	Owner's Taobao name	Store name	Date of opening	Monthly unit sold	Average selling price (Rmb)	Web Red? (name)	Weibo followers (K)
1	家有N多宝贝	戎美		79,339	300	No	
2	裙子卖掉了	吾欢喜的衣橱		75,427	200	Yes(张大奕)	
3	毛菇小象	毛菇小象		130,547	125	No	
4	小虫米子	小虫 Xiaochong		18,770	450	No	
5	wxyz_ing	大喜自制		36,727	200	Yes(赵大喜)	
6	madoujia	于Momo潮流女装		26,716	200	Yes(于Momo)	
7	dimplehsu	Dimple Hsu		14,093	450	No	
8	sarahzic	LIN Edition Limit		31,467	400	Yes(张林超)	
9	圣水无痕	Miuco		31,751	250	No	
10	alu_13	ALU online shop		22,199	500	Yes(方靖)	
	% Web Red stores by count	% Web Red by unit	% of Web Red by GMV				
Top 10	50%	41%	45%				
Top 20	40%	41%	41%				
Top 30	47%	34%	40%				
Top 50	46%	36%	41%				

Source: BLRI, Taobao.com (as of 4/1/2016)

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Exhibit 9 shows the profile of top 10 Taobao stores for women's clothing section, half of which are Cyber Celebrities. GMV-wise we estimate Web Red stores contributed 45% within top ten, 41% within top twenty, 40% within top thirty and 41% within top fifty.

From Exhibit 9 we can see the so called Web Red today are mostly ex-Taobao models wearing a girl fashion inspired by Japan's Enko Girls. This is a reason we believe there will be natural growth bottlenecks for this kind of Web Red. Web Red, broadly defined, can touch on various social fields. Their commercial value, however, varies greatly.

Another obstacle faced by Web Red Economy is its weakness in supply chains. Web Red stores sell small quantity of cloths procured from overseas or made in local factories. Its curated-sale selling model ensures high spot-demand when new style is photographed, but also limits its throughput, in our view. Cloths sold by Web Red stores usually have high average selling prices (ASP), which also limits its demand. In a nut shell, narrowly defined Web Red Economy is a niche market.

Fast Fashion and cross-border e-commerce enabled Web Red stores

In our view, Web Red Economy isn't new. Jumei (JMEI US, HOLD, TP: US\$7.0) has long practiced the curated sale selling model. Jumei and Web Reds cater to the same population segment, in our view.

Fast fashion and cross-border commerce are two trends supporting the flourishing of Web Red Economy. Together they alleviate the supply chain bottlenecks. Behind many Cyber Celebrities are professionally run fast fashion studios with deep roots in Tao-brands. Cross-border commerce skipped the design, manufacturing and logistic steps. A fashion buyer who is also a fashion model who happens to know how to act cute and answer questions on Weibo is recipe for a Web Red.

Web Red stores are still small comparing to Tmall brands (typically a Taobao store "graduates" to Tmall when getting big. But some choose to stay to avoid paying Alibaba revenue sharing). Among the top ten Tmall brands in 2015, there are three groups: (1) global fast fashion giants like Uniqlo, ONLY and Veromoda; (2) Tao-brands like Handu, Liebo, Inman and Artka; (3) offline apparel brands like La Chapelle, Orchirly and Lerting. Will Web Red overtake these Tmall brands? Or will they turn into Tmall brands employing multiple elements of marketing strategies?

Web Reds direct their own traffic through social media and networks and hence pay very little money to Alibaba. For Alibaba, hosting Web Red attracts user traffic which can be converted into purchases in other Taobao/Tmall stores. Hence Alibaba welcomes the arrival of Web Reds, for now, but for how long will Alibaba tolerate traffic that does not generate commercial values? Its handling of Mogujie and Meilishuo can be a case in reference. For Weibo, Web Red represents lost revenue opportunity. We believe Weixin is likely tighten the commercial demand on Web Red Stores, which might result in Web Reds flowing to Weixin. In the end, we believe what defines Web Red is social marketing technique, not new business model. As mobile traffic turning to social, all e-commerce enterprise must resort to social for traffic.

Is IP e-commerce real? Yes

Comparing to narrowly-defined Web Reds we are more interested in the broadly defined ones. There are at least three other groups that together make up the Web Red definition, in our view.

Web Red Economy, narrowly defined, are young girls wearing expensive, chic dresses with cosmetically surgical faces, often sponsored by a sugar daddy. But broadly defined they can touch on various social fields.

susugarsugar daddy

Web Red stores, though big on Taobao, are still small comparing to Tmall stores for women's clothing. In the future they will turn to Tmall stores.

Weibo might ask Web Red Stores to pay. Alibaba, for now, is tolerating Web Reds but it might also change.

- **Key Opinion Leaders (KOL)** in a variety of social subjects. The most famous one is Luogic Thinking (罗辑思维). The foundation of Luogic Thinking is a reading club focusing on business, liberal arts, history and philosophy. Its founder Luo Zhenyu (罗振宇) is an accomplished TV producer and talk show host. Through Weixin-based membership, book sales and video talk shows Luogic successfully generated an annual revenue north of Rmb200mn. Its business model is shown in Exhibit 10. Modelling on Luogic, a number of KOL focusing on history, cooking, military and cultural subjects have sprung up. These KOL ranges from teachers, musicians, race car drivers, political commentators to housewives. Sensitive social topics also get attention from the public. Xia He (夏河), for example, is an out-of-closet gay performer. His cosmetic store sells very well. Recently Luogic Thinking participated in the investment in Papi Jiang (Papi 酱), a short video talk show host, making a further step in exploring ways to commercialize IP.
- **Taobao Operators** who knows the Taobao rules for decades. With the help from social media/networks, they invented new marketing techniques like faddish item (爆款), premium stripped-down (高仿), pre-sale (预售) and custom made (定制). They are the ones often behind Cyber Celebrities. Some of them are couples;
- **Factory sponsored models.** Some Cyber Celebrities are sponsored by apparel factories, seeing how having a Web Red can help the factory sell.

Broad definition of Web Red signals the arrival of IP e-commerce, in our view. IP stands for branded traffic, which transcends traffic territories.

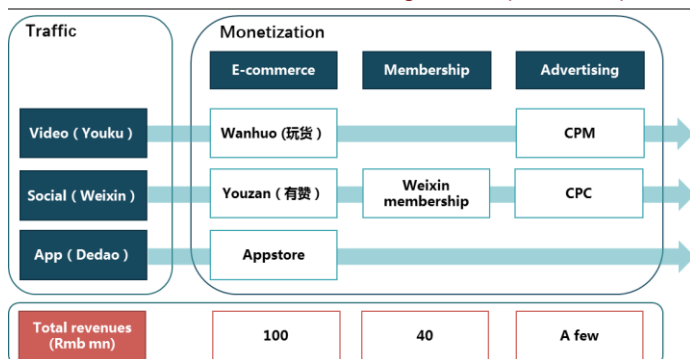
Social media and networks allow many to show off their respective talents. E-commerce is just one tool to monetize these eyeballs.

What is an IP? In our view, the most salient characteristic of IP in web parlance is branded traffic. IP is not new. In the PC client game days, Blizzard Entertainment is an IP, the Warcraft and Starcraft series is IP. In the unpredictable world of creativity, IP provides some predictive value, drawing viewership without the need for remarketing.

It is not true that only distribution channel can be platforms. In China it was the case (Tencent) but in US it was not. Besides Blizzard Entertainment, Disney is a platform that can be called an IP platform. Even though Disney also owns distribution (Capital City ABC, Miramax, etc.) but it doesn't command distribution. Combing distribution and content seems to be the common road for growth for US and China alike. In China there was Tencent earlier and Leshi now. Most of the problems facing by Xiaomi can be attributed to not being firm enough to pursue content.

Social media and networks allow many to show off their respective talents. E-commerce is just one tool to monetize these eyeballs

Exhibit 10. Monetization route of Lougic Show (罗辑思维)



Source: BLRI (as of 4/1/2016)

Exhibit 11. 2014-15 top celebrity income table

2015 ranking	English name	Chinese name	Occupation	Income (Rmb mn)	2014 ranking
1	Bingbing Fan	范冰冰	Actress	128	4
2	Jay Chou	周杰伦	Singer	102	1
3	Jackie Chan	成龙	Actor	96	17
4	Eason Chan	陈奕迅	Singer	86	7
5	Xiaoming Huang	黄晓明	Actor	79	10
6	Nicholas Tse	谢霆锋	Actor	78	43
7	Na Li	李娜	Athlete	75	2
8	Andy Lau	刘德华	Actor	70	5
9	Yifeng Li	李易峰	Actor	69	NA
10	Li Sun	孙俪	Actress	67	62
11-99				2,970	
Total				3,820	3,874

Source: Forbes (as of 4/1/2016)

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The foundation of fast fashion is standardized product, modular production and unified distribution channels. Fast fashion monetizes eyeballs with physical goods. But there exist other, often easier ways of monetization.

Individual, instead of institutions, is what people trust these days

In the field of e-sports (电竞), Cyber Celebrities commands hundreds of millions of Rmb endorsement contracts by recommending PC's, joysticks and other computer peripherals. Their endorsement often does lead to pouring of purchases to justify their price tag. Thanks to relatively few brands, e-sports Cyber Celebrities can make a fortune without touching hard labour of e-commerce.

What defines an IP from a brand? Emotional attachment is common. But IP more manifests itself more as an individual preference instead of a symbol of quality assurance. Social media and network empower the individuals in ways never happened before. Web population looks for "temperature" (温度) to visualize their counterparties to build emotional attachments. We believe the rise of IP more or less symbolizes the mistrust of anything institutional in China, even though many of these individuals have institutions behind. Web population prefer their instantaneous observations to decide whether to maintain emotional connection with their idols because it is more real. In the days of social, idol creation has become more democratic. This is what all commercial enterprises must face with.

Supply chain constraints reduce potential of IP e-commerce

For IP to play a bigger role in e-commerce, there are additional difficulties in supply chain orchestration. For fast fashion to work, there must be high level of product standardization, production modulation and most importantly unified distribution channels. We can see clothing is anything but standard, but distribution wise social media has become highly concentrated. That's why we see IP e-commerce more easily take place in digital goods distribution. Now with short video capability, more and more people can become digital IP producers.

Monetizing influence doesn't have to be through e-commerce

In our view, the C2C aspect of social commerce has two versions: Web Red Economy (or Social Media Commerce) and the Social Network Commerce. The former comes out of social media like Weibo, targeting followers who are mainly strangers. The latter comes out of social network like Weixin, targeting friends who are mainly acquaintances.

The Social Network Commerce market is bigger than Social Media Commerce market (Exhibit 8) for three reasons: (1) Social Network Commerce is not a convergent economy but Social Media is, which may limit its headroom to grow; (2) Social Network Commerce is segregated in its traffic, meaning shop owners must purchase advertising slots. Social Media Commerce is congregated in its traffic, meaning shop owners conduct they own advertising; (3) Social Network Commerce has more dimensions, making it less fickle than Social Media Commerce. In a Web Red Economy the shop owner does his/her own marketing, which makes the hosting platform less likely to monetize, and also makes it harder to scale.

If the problem of Web Red Economy is scale, that of Social Network E-commerce is trust. We estimate that in 2014, more than half of Weixin e-commerce is multi-level marketing (pyramid scheme), of which majority is dubious cosmetics products. The situation highlights the dilemma of social e-commerce. In our view, a rational purchase decision usually involves multiple steps. Social media and network can play a role in multiple steps, but the last step may not necessarily be social

Fast fashion is encroaching many aspects of modern life. The foundation of fast fashion is standardized product, modular production, unified distribution channel.

People trust individuals more than brands, signaling the lack of trust for anything institutional in China.

For many real celebrities, e-commerce is too cumbersome and risky as a monetization route. Endorsement, speeches and books can be far easier and less risky.

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(if it is it is more likely an impulse purchase). The case when it is social is when it, more or less, involves some forms of abduction, daydreaming and coercion. Lacking other competencies like logistics, quality or service, social e-commerce can easily degrade to one of these forms by merchants going the route of least resistance. Question is, how sustainable is an industry sustained by ill-oriented emotions?

E-commerce is perhaps one of the least desirable means of monetizing influence. Exhibit 11 shows the 2015 income of true celebrities. Top 100 add up to Rmb3.8bn. Many real celebrities undersell cyber celebrities. Real celebrities shun e-commerce because supply chain is too long and quality control too hard. Endorsement (代言), speeches and publishing are far more straightforward and less risky ways to monetize their influences. Down to the profit level there is no difference. If we restrict the impact of social to the steps of decision making, social e-commerce's role might be a form of Native Ads.

Social e-commerce also changed the game for brand

C2C social e-commerce kills advertisement. But is advertisement really killed? We don't think so. Web Red to date only happens in a selected merchandise category that involves a selected demographic with the help from imports, skipping the hard part of supply chains. Cyberspace empowers the individual but at least at this moment, this empowerment is illusionary when it comes to the offline part. Trust and trust of institutions are the foundations of modern society. If a merchandise is a collaborative effort, then claiming individual ownership is not only hypocritical, but also untrue.

We believe social e-commerce's broader impact on e-commerce market is still advertising. In the long run, there might be even bigger advertising market. The paid search model plays a central role in an intermediated e-commerce, but it has many problems. Paid search reduces selection criteria to single dimensions, price and (previous) volume, leading to vicious competitions and manipulations. General search can still use broad match to broaden search scope. E-commerce search cannot. Web page search still allows design creativity and flexibility to enhance conversion. E-commerce search can only be performed on templates provided. These two reasons led to the existence of huge SEO (Search Engine Optimization) and SEM (Search Engine Marketing) industries for search but for Alibaba there only exists a smaller e-commerce outsourcing (代运营) market carried out by companies like Baozun (BZUN US, NR). We believe social advertising service can be an even bigger market than SEO/SEM because the depth of service required.

Tencent-JD alliance is at the forefront of experimenting social e-commerce

Although off from a low key start, Tencent-JD's Jing-teng Initiative (京腾计划) has great potential, in our view. We believe by 2019, 8.7% of JD's GMV will come from social network. From JD's point of view, it probably wants to build its own source of traffic and reduce its reliance on Tencent. But it is probably inevitable that its traffic source will increasingly come from Tencent's social ads.

Jing-teng is an initiative in which Tencent opens up its social network intelligence to JD in exchange for JD's advertising. JD gets the GMV. In 2015, we estimate only Rmb8.3bn worth of JD.com's GMV came from Tencent, lower than Weibo's contribution to Tmall which we estimated to be Rmb9.6bn (Exhibit 8). But we believe Jing-teng GMV will grow at a CAGR of 25% to 2019, making brand social e-commerce the largest sub-segment within social e-commerce.

Web Red marketing is a form of native ads

We believe social commerce's end game is not to eliminate advertising but to enlarge it

Comparing to social e-commerce for C2C, that for branded B2C/B2B2C has higher potential in our view

Exhibit 12. Tencent and JD.com promote the “brand e-commerce” concept



Source: Tencent (as of 4/1/2016)

Social commerce is deflationary for Alibaba, but will Tencent collude?

Social network/media opens up alternative source of traffic, which is deflationary to Alibaba’s take rates. As long as Tencent keeps providing mobile commerce infrastructure service for free, it will be difficult for Alibaba to monetize. Tencent can fight a traffic war, or collude with Alibaba to monetize.

Tencent’s recent decision to charge commission to cash withdrawal from Weixin Payment showed it had a rational attitude towards social commerce competition. During the New Year holidays, user dispense of Red Packet cost Tencent Rmb300mn of profits, which led to Tencent to adopt measures to stem the loss. Whether Tencent chooses to continue to provide mobile commerce infrastructure service (Weixin store and Weixin Payment) for free, or collude with Alibaba to charge depends on which route maximizes Tencent’s self-perceived interest and risk. If Tencent can find an alternative way of monetization, such as contextual advertising, then it might keep the infrastructure service for free for a long period of time. But in the long run, under Tencent’s rational management style, the chance for collude with Alibaba overweighs the chance for a drawn-out war, in our view. This outcome is investor-friendly.

We believe Tencent will collude with Alibaba to maintain the profitability level of social commerce at reasonable level. This outcome is investor friendly, in our view

Advertising as the ultimate business model

During the early days of China Internet, advertising is an inferior business model to Freemium. Both Alibaba and Tencent are Freemium model practitioners. In a Freemium model, majority of users use for free, some users pay to exchange for privileges over others. This model, over time, has shown its weaknesses. The biggest reason, in our view, is when the rule is made explicit, users tend to manipulate.

Google shows that with almost unlimited advertising inventory, advertising can be a superior business model too. More so, Google shows that if advertising is seamlessly blended in the displayed content, users do not object. Tencent has successfully practiced this product philosophy too. Among an array of MMOG game companies, Tencent has long made its paid user privileges less noticeable comparing to other MMOG companies.

Machine based advertising has proven its prowess as a business model, which can be Tencent’s medium term source of competitiveness. Another source is Native Ads.

In a Freemium model, those who gets and those who don’t eventually cannot live together. Most of the online games see their in-game social structure collapse. The increasingly worsening Taobao ecosystem is another case in point. In our view, Taobao is free-to-play game and eBay is a pay-to-play game. How to balance user experience and paid user privilege is a common question for both.

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The machine is the answer. Nativeness of advertising is another. In both search and recommendation the match is made by machines. Machine-based matching through big data technology is what we believe can improve advertising targeting. Nativeness is another area we believe can further this goal of balancing. This area of transformation is the second area in which we believe Tencent is strategically ahead of Alibaba.

The war on mobile payment: can AliPay and TenPay both win?

Besides social e-commerce, another battle ground between Tencent and Alibaba is mobile payment. Tencent's mobile payment solution TenPay stem from Tencent's earlier effort in Paipai C2C e-commerce, which started as a venture to compete against Taobao and eBay EachNet. TenPay started as a venture to compete against AliPay. The question is not about whether these two can catch up with No.1 Taobao/Alipay but really what value do they create in the new mobile Internet environment that can give them the chance to corner overtaking the market leader.

The way Tencent plays Weixin and mobile QQ is to take on the role of "kingmaker" in new Internet fields, mostly O2O.

Exhibit 13. The closed loop shopping experience of Weixin e-commerce



Source: Tencent (as of 4/1/2016)

The Closed Loop Mandate calls for mobile payment capability

After the 2012 3Q War between Tencent and Qihoo (QIHU US, NR), Tencent started to open up its ecosystem. Opening up is technically infeasible in the PC client and feature phone QQ era, more feasible in the browser-based Qzone era and most feasible in the Weixin+QQ era.

These developments led to Tencent opening up its traffic source with a wide range of partners in respectively fields Tencent cannot or do not want to compete. Tencent plays this strategy well, but one area that cannot be delegated to partners is payment. One of the three Mandates: Closed Loop, calls for payment as a basic infrastructure service. This role isn't unfamiliar because Q-coin (QB) played a pivotal role in shaping Tencent's competitiveness in online game. But payment follows consumption. QB is successful because Tencent dominates online game. Now with O2O coming, the reason for the existence of a virtual currency only for the purpose of virtual good consumption is gone. QB must merge with TenPay.

Closed Loop is an important feature of the mobile Internet. It connects online and offline. It is especially important because we estimate close to 71% of social retail sales need some kind of offline infrastructure support, ranging from showroom (furniture, house and cars), to local food preparation, to special transportation and storage (grocery, catering and gasoline) and to local services (restaurant/Catering). For e-commerce to move forward, these offline categories must fall for penetration. Mobile Internet makes these penetrations possible, which we broadly refer to as O2O. The progression in O2O holds vital importance to e-commerce as penetrations to traditional

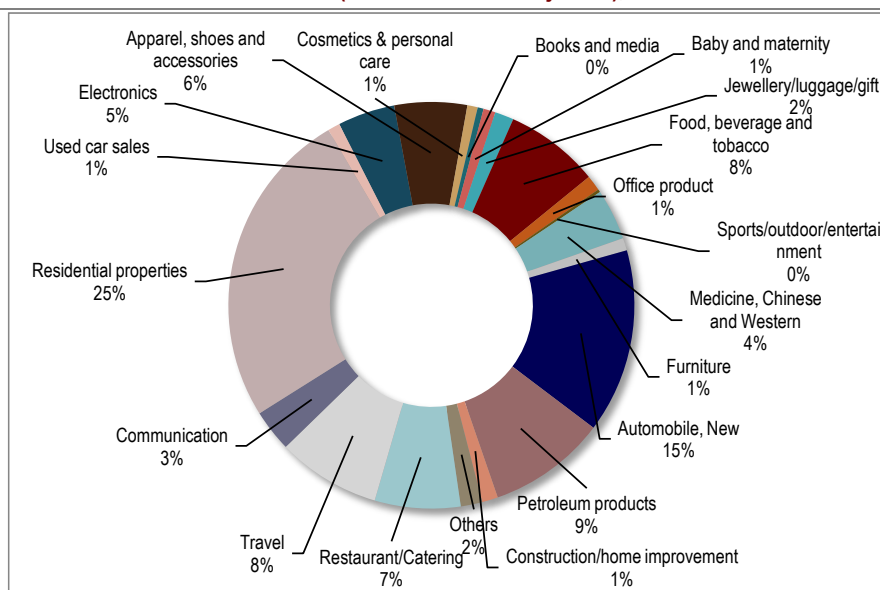
Closed Loop is a new consumer experience in which a seamless, 100% online experience now exist from discovery to payment.

O2O holds vital importance to the future growth of e-commerce. O2O calls for closed loop payment capability.

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e-commerce categories, which do not require offline infrastructure support (Apparel, Electronics, Cosmetics, Baby & Maternity, Books, etc.), have reached 40-50%.

Exhibit 14. China's social retail sales (total=Rmb37.2tn adjusted), 2014



Source: NBS, BLRI (as of 4/1/2016)

Without O2O, e-commerce has entered a phase of growth bottleneck. But O2O faces tremendous offline logistic hurdles. This is the dilemma of e-commerce today.

Closed loop changes the rule of game for many industries

Closed Loop also has an important implication to its business practitioners. It is 100% online from discovery to payment. This means there is no attrition for customer acquisition and reduced need for reacquisition. Many businesses who rely on re-advertising lost their businesses, in our view. Their business will be shifted to the social and payment platforms with service companies who provide native ads and big data based matching.

Our study of Weixin Payment showed that after the launch of Weixin Payment, the market share of TenPay increased dramatically and roughly equals to the market size of Weixin e-commerce, O2O and money transfer.

Closed Loop changed the rule of competition for many industries.

Exhibit 15. China 3rd Party mobile payment industry size and Weixin Payment share

Quarter	Total transaction (Rmb bn)	TenPay market share	Estimated Weixin Payment market size (Rmb bn)	Note
1Q13	60.5	4.20%	0	
2Q13	117.4	4.60%	0	
3Q13	296.5	4.20%	0	Weixin 5.0 launched with payment
4Q13	701.6	3.30%	0	
1Q14	1437.5	13.80%	151	Weixin tie card payment launched
2Q14	1383.5	9.30%	83	
3Q14	1433.3	10.60%	105	
4Q14	1791.8	12.05%	157	Red Packet promotion
1Q15	2001.6	13.50%	204	
2Q15	2296.6	16.35%	300	
3Q15	2420.5	19.20%	385	

Source: iResearch, BLRI (as of 4/1/2016)

AliPay and TenPay are becoming increasingly alike

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Because Tencent recently reorganized the relationship between TenPay, QQ Wallet (QQ 钱包) and Weixin Pay (微信支付), we collectively use TenPay as AliPay's counterpart to describe Tencent's competitive strategy. Simply put, TenPay will be the payment technology behind QQ Wallet and Weixin Pay while the difference between QQ Wallet and Weixin Pay will be mainly demographical.

In our view, TenPay and AliPay are becoming increasingly similar, which indicates Tencent is a rational competitor taking into consideration that the entire online payment and Internet finance industry is under government scrutiny and face competition from traditional financial institutions.

Both TenPay and AliPay now consist of three mobile payment scenarios:

- **In-app purchase within own e-commerce properties:** This means AliPay supports payment on Taobao and Tmall while TenPay supports payment on Weixin e-commerce (微商);
- **In-app purchase with external e-commerce properties:** TenPay had a head start with leading e-commerce/O2O leaders like JD.com, Didi, Dianping and 58, but AliPay is catching up quickly. Thanks to aggressive promotions, AliPay is now the first/left icon displayed in many apps;
- **Offline Two Dimensional Code payment:** This encroached on the territory of China UnionPay (中国银联) but since the regulation opened up AliPay has move in aggressively. TenPay followed.

We believe that besides government regulations, the strategies of TenPay and AliPay must also be viewed under the context of Apple Pay's entry to China via a partnership with China UnionPay.

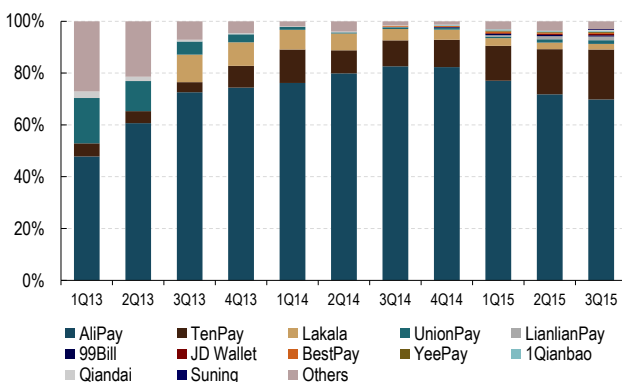
Can TenPay and AliPay both win?

We believe so. TenPay leverages mobile Internet to cut into the payment market and stays focus on the high growth segment of the sector. Mobile Internet is reestablishing people-to-people relations on line, which gives Weixin and Weixin Payment a natural advantage. As a result, TenPay has been gaining market share at the expense of AliPay (Exhibit 16).

As regulatory landscape becoming increasingly clearer, AliPay and TenPay also become increasingly similar.

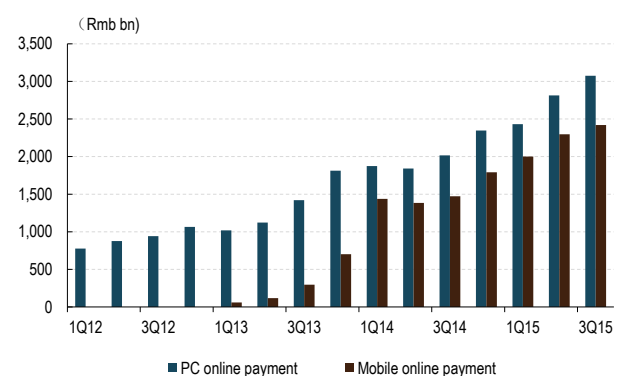
TenPay, AliPay and ApplePay/UnionPay are three forces competing in the field of mobile payment.

Exhibit 16. Mobile payment market share



Source: iResearch (as of 4/1/2016)

Exhibit 17. Mobile payment vs. PC payment



Source: iResearch (as of 4/1/2016)

We expect TenPay's market share to go further up to maybe 25% in 2016 but going further will meet increasing resistance, in our view. This is because: (1) AliPay as a cash management tool still has unparalleled advantages. AliPay's role as a virtual account, despite being cautiously looked upon by the central bank, still has great consumer appeal. We also expect the central bank to ease the oversight on Internet banks in the future and thereby legitimize AliPay's super-account status; (2) Two Dimensional Code Payment is a transitional technology. We expect it to be replaced by

With UnionPay POS supporting NFC and Apple's new iPhone 7 equipped with ApplePay, Walk-In mode of mobile payment will regain market share, in our view.

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NFC (Near Field Communication) payment starting from 2016 with Apple supporting NFC in iPhone. By the time UnionPay will launch a comeback offensive by leveraging its extensive offline POS network. In 3Q15 UnionPay only has a minuscule 1.5% market share in mobile payment. We expect it to go up to 10% as it transferring some of the offline bank/credit card acquisition transaction to mobile payment.

Apple Pay and Meituan-Dianping: two new competitors in payment

In February 18, 2016, Apple formally opened its Apple Pay feature on iPhone 6 and 6S. NFC can not only process payment but has other usages like door access, car access and file transfer, etc. Now about 40% of UnionPay's POS has equipped with NFC chips and about 40% of smartphones have NFC capability. Apple Pay is vital for UnionPay because we estimate that by the end of 2015, Apple sold 65mn units of iPhone 6 and 6S with NFC capabilities, or 8% of China's 790mn mobile phone install base. Further, we expect Xiaomi 5 to support NFC when it goes into production in mid-2016.

Besides Apple-UnionPay alliance, we believe Meituan-Dianping could also be a formidable competitor. Dianping's Shanhui (闪惠) product is already a group-buying-bundled payment solution. Meituan-Dianping can easily amass market share by converting group directing transactions to its own payment solution. In 2015 we estimate Meituan-Dianping had more than 80% market share in the Rmb160bn group buying market. Although mobile payment is an Rmb12tn/yr. market, we estimate only 25% of this Rmb12tn are consumptions (the remaining are money transfer, fund purchase/redemption and utility payment, etc). If Meituan-Dianping converting all its transaction to its own payment solution, it can capture ~4% of the consumption mobile payment market.

Meituan-Dianping can capture 4% of the consumption mobile payment market if it launches its own payment solution.

O2O alone is not sufficient to shake AliPay's dominance

We estimate that AliPay has ~4,000 employees while TenPay has ~400. TenPay was born with less burden and therefore more tuned toward mobile Internet. But AliPay has deep roots in the payment industry, understanding the market and policy better. Most of the recent innovations, like Yuerbao (余额宝) and Two Dimensional Code, come from Alibaba.

For Alibaba, AliPay is the cornerstone of its Internet finance initiative that will eventually cover every aspect of banking. For Tencent, TenPay started as an add-on of its e-commerce effort in Paipai, now repositioned to be an add-on of its social e-commerce and O2O effort. AliPay has higher ambitions while TenPay is a follower with a focused approach in hope to corner surpass the leader.

O2O alone and social e-commerce alone cannot let TenPay surpass AliPay in market share. But TenPay's follower strategy makes more sense, in our view.

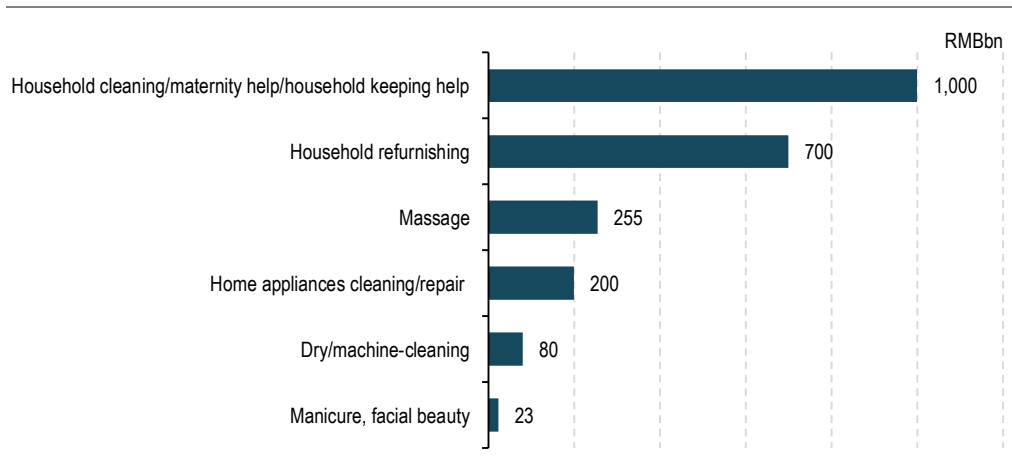
In our view, TenPay's strategy is more worth the bet because: (1) Tencent overall has a more clear-cut partnership strategy (enabler) and value propositions (online traffic for offline service) to its partners (Exhibit 6) than Alibaba does. Payment is a consumption scenario driven business. This means TenPay will continue to gain share; (2) Tencent can follow most of Alibaba's ground breakings in regulation and business models. Finance is not a winner-take-all market, (3) Tencent's traffic advantage can help it gain share.

Quantifying the service economy: how big is it comparing to retail pie?

As shown in Exhibit 14, O2O on a narrowed sense mainly affects Restaurant/Catering (7% of social retail sales), which is too small a market for TenPay to establish an overwhelming advantage over AliPay, not to mention Meituan/Dianping might launch its own payment solution. O2O on a broader sense affects Food-Beverage-Tobacco-Alcohol, Gasoline, Medicine, Automobile and Real Estate. But we can hardly see TenPay enjoying any competitive advantage comparing to AliPay and UnionPay. Many transactions in these categories are wholesale in nature, which means a credit card may suit just fine. In addition, we believe there is already substantial bubble in the area of group buying O2O. As we know, payment follows consumption. We also estimate the share of social e-commerce as percentage of online retail is <10% by 2019. These two market sizes do not warrant a big enough scenario for payment for TenPay to overtake AliPay, or Tencent ecosystem to overtake Alibaba ecosystem in payment industry as a whole. Does the answer change if we include home services?

Currently in O2O, fresh produce and housekeeping have run into business model difficulties. Restaurant/catering is inflated

Exhibit 18. To home service market size



Source: NBS, Ministry of Civil Affairs (MCA), CCIA (China Cleaning Industry Association), BLRI (As of January 25, 2016)

The service economy is not counted in the retail pie. It consists of Household Cleaning, Maternity Help, Housekeeping, Massage, Appliance Maintenance, Laundry and Manicure/Facial. Together we estimate it is an Rmb2tn a year market. This market size comparing to the Rmb37tn retail market is still very small, in our view. Hence we believe O2O as a consumption scenario cannot shake Alibaba's dominance in e-commerce.

O2O as a payment consumption scenario is not sufficient to shake Alibaba's dominance in e-commerce

UnionPay will not go away

Even in the narrowly defined O2O space, here are two kinds of O2O payment modes. One mode is **Online Booking**, in which the consumer and the merchant connect via online means and complete the payment step as a follow up of the online transaction. This is where Tencent, through its partnerships, have a natural advantage. Another mode is what we call **Walk In**, in which the consumer walks into the premise and consume service without booking. Both ApplePay and UnionPay are Walk In payments. Both are cash-less. In our view, Walk In will constitute at least 50% of the mobile payment volume because of its convenience, in our view. This further reduces the addressable market for AliPay and TenPay both, more so for TenPay.

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A comprehensive business shift to advertising

When Tencent started in 1998, Freemium has been its trademark business model. In a Freemium model a few users pay for privileges while most users use for free. Online game exemplified the Freemium model and took Tencent to the height of China Internet. Tencent has been consistently making effort to broaden its advertising footprint, eventually leading to the breakthrough in GDT (广点通). Tencent’s advertising business mainly benefits from unique and high quality platform traffic, steady ecosystem buildup and most importantly, the advancement in big data technology in advertising.

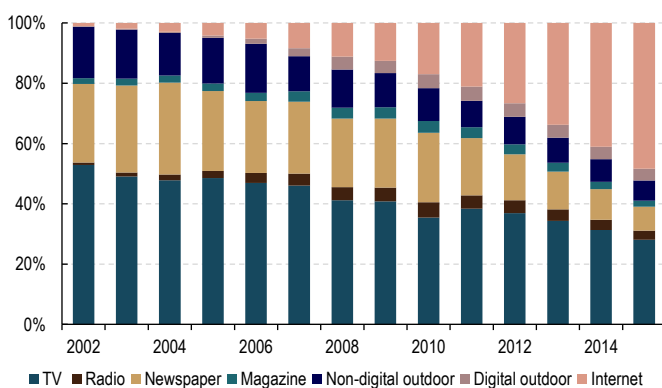
What timing and Tencent has done right in advertising

Tencent was not known for advertising until 2012 when GDT gathered momentum. Before that, market always viewed Tencent’s success in advertng as a result of brutal force. Tencent overtook SINA in portal advertising in 4Q12 and gathered momentum in video advertising against Youku. In 2015 we estimate Tencent had 22% and 23% revenue share in portal (No.1) and video advertising (No.1). Relying on unparalleled traffic advantages, Tencent achieved remarkable success in brand advertising. But in SME advertising, Tencent’s Soso failed and must be sold to Sougou in 2013. Why?

In the beginning it is because QQ is a PC client without external link ability. Hence Tencent used popup windows to transfer its QQ traffic to its portal qq.com. Next it is because brand advertising in China for many years weren’t performance based but influence based. It took years for Tencent to steadily build up its advertising ecosystem with agencies and brands. For many years brands pay for influence, not for clicks. Lastly, SME advertising has huge upfront cost for channel buildups. SEO and SEM employs thousands of experts to help SME use search. Tencent lacks such ecosystem. With the advent of social network/media and mobile Internet these obstacles have since dissipated.

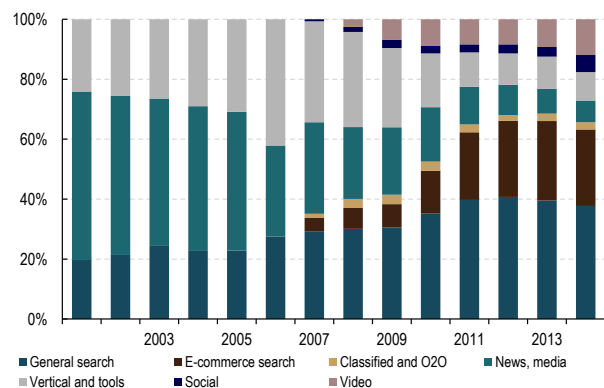
Tencent has won the brand advertising war against SINA and Youku/Tudou in revenue shares.

Exhibit 19. China advertising market breakdown



Source: iResearch, BLRI (As of 3/31/2016)

Exhibit 20. China online advertising breakdown



Source: iResearch, BLRI (As of 3/31/2016)

As Exhibit 19-20 show, search is very important today. In 2015, General Search (Baidu, Google, Qihoo and Sogou) was 38% of China’s online advertising market and E-commerce Search (Alibaba) was a further 26% but search’s overall share already peaked in 2013. Because advertising is a business highly correlated with GDP, in a slowing economy, rising share of Social and Video Advertising must mean declining shares of other advertising formats. The question is will Social

The dominance of search in market share in Internet advertising is huge.

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Ads eventually take the role of Search in market share? We believe the chance is remote but it doesn't prevent Social Ads to be the fastest growing Internet Advertising segment for years to come.

Monetizing China's Facebook is just beginning

Tencent owns the richest and most comprehensive media resource in China, covering portal, news client, tools, video, instant messaging and SNS. It lacks search traffic. Social ads is Tencent's opportunity to overtake search.

System buildup is why it took long for Tencent performance ads to emerge

Tencent always had the biggest traffic in China Internet but before browser-based Qzone gained popularity in 2008 the biggest source of Tencent's traffic was QQ, a PC client that does not support external link for advertising. Between Qzone establishing No.1 position in social networking and the success of GDT there was also a gap of almost five years. This five years was spent on system buildups.

Baidu's launch of PhoenixNest (凤巢), its automatic advertising bidding system, in 4Q09 and its subsequent runaway success in 2010 showcased the great monetization power of a machine based advertising matching system. From set up in 2007 to launch in 2009 it took Baidu three years to complete development and one more year to see the business results. After seeing the result of PhoenixNest Tencent wasted no time in setting up GDT in 2011 and took just one years to complete development. The timeline fits.

The rise of Tencent's advertising follows a natural trail from brand to performance.

Ad Exchange helped Tencent gain advertiser's attention

In our view, the advancement in Ad Exchange technology and the corresponding education on the advertisers readied GDT for its debut. In China traffic fraud rendered Ad Exchange and its corresponding technologies and formats (RTB, DSP, SSP, DMP, etc.) tractionless. Baidu, for fear of cannibalizing its own Ad Union business, was slow to move to Ad Exchange initially. Tencent became the only platform with all the traffic internal that can make Ad Exchange happen. This was when Tencent first grabbed advertisers' attention.

With mobile gaming slowing, the pace of advertising monetization gathered momentum. In 2015, Tencent's advertising revenues reached Rmb17.5bn, or 8% of China's online advertising market, comparing to 30% for Baidu and 21% for Alibaba. In 2020, we estimate Tencent advertising revenues to reach Rmb65.5bn, or 12% of the market.

Baidu and Alibaba now face competition from Tencent in advertising.

Weixin Moments, video and news app will be key ad drivers for 2016

In 2016-17 we believe key drivers for Tencent's ads revenue will be from Weixin Moments (朋友圈). Strong performances in video advertising and news app advertising are also high certainty events.

Weixin Moments Ads copy the success book from mobile QQ and Qzone

Benefiting from high quality traffic and user attention, we expect Weixin Moments Ads to be a certain success, a bonanza especially for brand advertisers. We expect Weixin Moments Ads to meaningfully drive Tencent's advertising revenue in 2016.

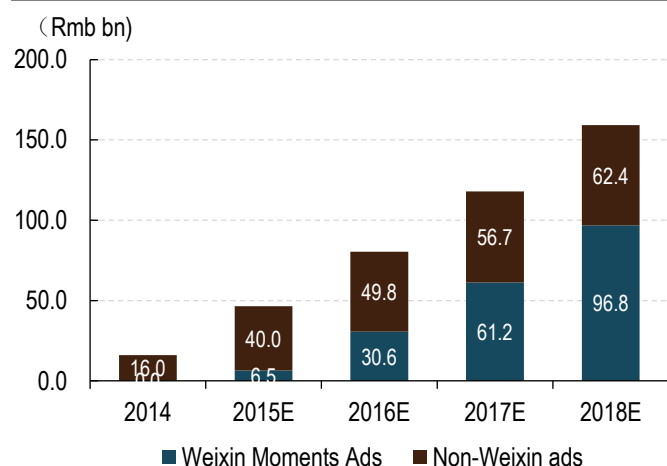
According to our understanding of 1Q16 advertising policy, Weixin Moments Ads will be CPM based and priced differently by geographies and ad formats. Video ads will be priced higher than graphic-text ads. Ads to first tier cities will be priced higher than ads to lower tier cities. First tier city CPM-based graphic-text ads price start at Rmb150/thousand impressions while video ads start at Rmb180/thousand impressions. Minimum advertising threshold is lowered to Rmb50K per campaign.

Comparing to mobile QQ and Qzone, Weixin users are higher end and therefore warrant higher advertising premiums. In 2015 we estimate mobile QQ advertising revenues reached Rmb8bn. According to iResearch, the launch times of Weixin was 1.6x of mobile QQ. Therefore we estimate the revenue potential of Weixin Moments Ads is at least Rmb12.8bn and take into consideration of Weixin's high end premium, we believe Weixin Moments Ads should deliver Rmb15-20bn annual revenues in 2018. We estimate 2016 Weixin Moments Ads revenue at Rmb6.1bn, not a small number considering prior year this figure is Rmb900mn.

Machine based advertising allows Tencent to build an SME advertising business without resorting to an on-the-ground distribution network.

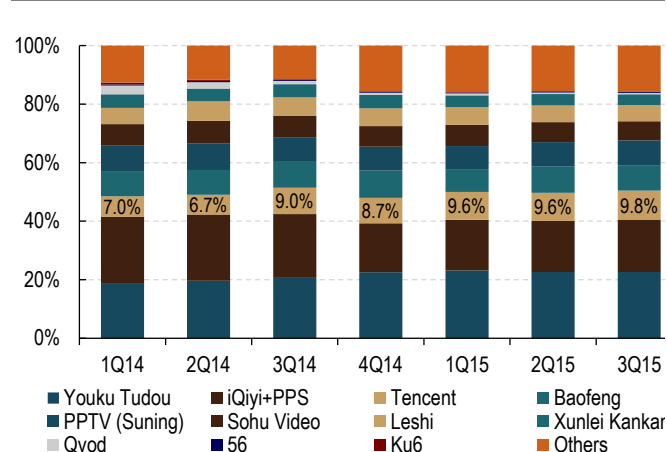
We put estimate of Weixin Moments ads at Rmb6.1bn in 2016, up from Rmb900mn in 2015.

Exhibit 21. Tencent performance-ads revenue estimate



Source: BLRI, Tencent (As of 3/21/2016)

Exhibit 22. Online video time spent market share



Source: iResearch, BLRI (as of 3/21/2016)

News app and online video are solid sources for growth

Tencent has bigger traffic share on mobile than on PC, it also has opportunity to gain revenue shares on mobile. One such opportunity is news app. The other is video. Readers are more easily identified on mobile, allowing better advertisement targeting than PC portal advertising. There have been various statistics showing different rankings but in general Tencent News is one of the top two news apps in China (Exhibit 23). We estimate Tencent News app already generated Rmb2bn worth of revenues in 2015, comparing to Toutiao's Rmb1.6-1.8bn. We expect Tencent News app revenue to double in 2016.

Video ads is another growth engine. We estimate Tencent's video ads has surpassed Youku Tudou in 4Q15 and was in neck-to-neck competition against iQiyi. In our view, video ads is increasingly merging with TV ads under the convergence of mobile with television. Each year TV ads market adds up to more than Rmb100bn while online video ads just surpassed Rmb25bn in 2015. With smart television gaining tractions, online video players like Tencent, iQiyi (Baidu), Leshi and Youku Tudou all are expected to enjoy the fruit of high growth rates in the coming years.

Tencent has zeroed in Toutiao in the news app arena. News apps on mobile have inherited the ads budget from news portals on PC.

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According to iResearch, Tencent Video user time spent ranks No.3 with about 10% market share, behind Youku Tudou and iQiyi. These three together with Leshi spend large amount of content acquisition budget each year and actively develop original contents. Tencent has strong traffic foundations in Weixin and mobile QQ, with a deep pocket to invest in content. Hence we hold a positive view on Tencent Video's future potentials to build a solid foundation for monetization in 2016-17.

Tencent's video ads revenue has overtaken Youku Tudou in revenues and was in neck-to-neck competition against iQiyi by 4Q15.

Exhibit 23. News app market share by various sources

	iResearch*	Analysys	iiMedia	DCCI	Sootoo
Nature of market share	Time spent	Time spent	Active user	Android active user main use	Download times
Tencent News (腾讯新闻)	31%	23%	38%	28%	33%
Toutiao (今日头条)	18%	26%	32%	14%	20%
NetEase News(网易新闻)	13%	14%	33%	26%	10%
SOHU News (搜狐新闻)	15%	17%	30%	15%	9%
SINA News (新浪新闻)	9%	6%	17%	9%	2%
Phoenix News (凤凰新闻)	7%	11%	12%	8%	5%
Baidu News (百度新闻)	1%	3%	11%	0	2%
其他	6%	0%	15%	11%	19%
Total	100%	100%	NA	100%	100%

Source: iResearch, Analysys, iiMedia, DCCI, Sootoo (as of 4/1/2016)

Ecosystem supports sustainable growth

Besides traffic advantages, Tencent has also been involved in the advertising business for long period of time and established steady advertiser ecosystems for sustained growth. Tencent's advertising platform has three components:

- Advertisers within the social networks, for example, the public account (公众号) system within Weixin and mobile QQ;
- Third party platforms like JD.com, 58 and Meituan-Dianping with traffic needs from Tencent. These third party platforms grow with Tencent and returns their revenue back to Tencent platform to advertise;
- Third party DSP (Demand Side Platforms) connected through Tencent's Ad Exchange (ADX). These platforms also service to enlarge Tencent's overall advertiser market share.

Take an example of Weixin Public Account (公众号), which has formed a virtuous ecosystem. In 2015 Weixin Public Account achieved 3bn page views, Rmb20mn reader-to-author rewards (打赏) and Rmb1bn revenue share paid to Account owners. If all 3bn page view can be monetized at a rate of CPM of Rmb5, full year Public Account Advertising potential could reach Rmb5bn. This is in addition to the Weixin Moments Advertising (朋友圈) we calculated earlier.

Weixin Public Account is another advertising bonanza after Weixin Moments.

Targeted advertising driven by big data is the long term growth engine

Tencent has the most comprehensive media resources and highest user stickiness in China Internet. Investment and cooperation with e-commerce and O2O leaders further polished Tencent's shortcomings in consumption and transaction related user data area. Now Tencent's social data is fully competitive against Baidu's search behavior data and Alibaba's consumer behavior data in

Tencent's social data, Baidu's search behavior data and Alibaba's consumer behavior data complement each other.

See the last page of the report for important disclosures

the data technology arena. The ensured competition among BAT will be on acquiring other party's data competency to complement its own.

The biggest advantage of Internet advertising over traditional advertising is its measurability and one-to-one marketing segmentation. Both Baidu search and Alibaba through-train (直通车) are user-initiated advertisement, hence are targeted by nature with high advertising value. Comparing to them, Tencent's social data focuses on guessing what the users want, followed by targeted recommendation. Because of this, Tencent's ads have bigger room for improvement and is still at the early stages of its development. Development areas like machine learning and neuro-networks have bigger rooms of application in social than in search, in our view.

Comparing to Alibaba and Baidu, another advantage Tencent holds in big data is that its social network ID has generality (普遍性), uniformity (统一性) and exclusivity (唯一性). This allows Tencent to draw a 360-degree picture of the user throughout his/her entire consumption life cycle. The more Tencent accumulates these data, the more knowledge Tencent gains from this user and the higher the click through rate can be. This leads to numerator and denominator of the ROI to increase proportionally, leading to more sustained revenue growth. Although consumer behavioral data has more immediate implication for Baidu, overtime it does not lead to accumulated user profile. When search behavior declines, the associated data also declines. This is why Baidu has been focusing on building a user account system.

Last, but not the least, Internet advertisement as a sector is still at early stage. Data and precision have not entered the advertiser mainstream. The knowledge level of the advertiser and ad design ability still have bigger impact than data in advertisers' minds. This means Tencent has more room to grow. From the long term view Tencent's effort in big data should enhance its long term ability for targeted marketing and therefore build a solid foundation for sustained growth of its advertising business.

Search ads focuses on finding what the users want; social ads focuses on guessing what the users want. Therefore social ads have more room to improve.

Chinese advertisers are not yet sophisticated enough to use big data to achieve targetedness.

Looking beyond game, the future is bright

Even though we believe Tencent still has another great year ahead in mobile gaming, it is important to look beyond game to understand Tencent's interactive entertainment business, now 55% of its Rmb103 bn a year revenue stream. As a developing country, China's entertainment spending is still low by global standards. Entertainment technology changes but entertainment industry should continue to grow. In the medium term, IP and convergence are changing the competitive ball game. In the long run, AR/VR should further drive the expansion of the entertainment pie.

Entertainment spending is still low by global standards

China's entertainment spending per capita is low for two reasons: One, China is a developing country; Two, China has wide-spread intellectual property (IP) piracy issues. One must bear in mind, however, that Internet has different IP protection philosophy to begin with. China's entertainment industry enjoyed brisk growth, partially thanks to a liberal IP framework.

Liberal IP framework is what helped China to grow its entertainment industry in the early days, in our view.

Exhibit 24. Entertainment industry global comparison, 2014

(Rmb bn)	China	Hong Kong	Korea	Japan	USA
Games (PC, web, mobile, console)	109	1	25	77	138
Online Gambling/lottery	85	57	11	24	221
Digital ads	194	4	18	60	368
Online music	6	0.03	1.0	2.8	22
Online literature	2	0.12	1.7	7.5	39
Interactive entertainment	4	-	-	-	-
Online total	400	63	57	172	788
Movie	30	2	9	13	65
Offline gambling/lottery	297	98	111	121	1,127
Sports	92	0.5	40	226	1,657
TV, radio and magazine ads	266	34	51	192	820
Music publishing/Karaoke	5	0.3	0.7	14	9
Publishing	78	4	29	42.0	137
Offline total	768	138	242	607	3,557.9
Total entertainment (Rmb bn)	1202	201	298	780	4,352.8
Total population (bn)	1.368	0.0073	0.0506	0.127	0.3210
Spending per Capita (RMB)	878	27,532	5,894	6,147	14,344
Spending per capita ex-gambling	599	6,272	3,485	5,005	10,141

Source: iResearch, PWC Consulting, MPIA, Plunkette Research (as of 4/1/2016)

As Exhibit 24 shows, low gambling/lottery (legal) revenue is one reason why China's entertainment spending is low by global standards. Low sports, literature and music spending is another reason. China's entertainment spending per capita is 6% of US's, 12% of Japan's and 17% of Korea, ex-gambling.

Lacks of gambling is one reason why China's entertainment spending is low by global standards. Low sports, literature and music spending is another reason.

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Participation is the key to IP-driven entertainment economy

In our view, ownership and participation is the key to IP-driven entertainment economy, and is also where difficulties used to lie. Without claim to ownership, IP cannot be valued. Without participation, IP cannot be valuable. The difficulty is to be simultaneously valued and valuable. Over the past three years, thanks to mobile Internet, the development cycle of online game dramatically shortened, allowing IP owners to monetize and maximize on their assets when the return is certain, leading to overall enhancement of IP monetization. Content has gained more voice over channels.

Mobile game plays a key role in bring the IP topic to fore

Convergence of entertainment isn't new. In developed countries, synchronizing product launch schedule has been a common practice. Even in the game world, convergence of console, single PC, PC client Internet, PC web Internet and mobile game has been experimented ten year ago by the likes of Nexon, EA and Activision. But neither trend happened in China, why?

We believe distribution channel dominance is a pre-condition for convergence. Channel dominance will always sacrifice on content quality. In the game industry, channel disruption resulted from hardware innovation took place about once every few years, making this pre-condition difficult to meet. Most studios did not survive these disruptions. In the US, movie plays the orchestrator of the convergence with Hollywood establishing the channel dominance globally. In China, online game, movie and publishing industry have different ownership structures, revenue scales and industry maturities, making coordination difficult.

Another reason for the difficulty of convergence is development cycles. Movie, game and publishing are three generation of technologies, each has developed its own set of rules and processes.

Ignoring these differences and link the art pieces with a vague term called IP can save marketing costs, yet for creativity industries cost is always an after-thought comparing to revenues. Mobile game changed this picture because development time for mobile game is short and investment small, yet revenue potential very big. Mobile game dramatically reduces the complexity to coordinate convergence initiatives. The flip side of it, however, is life cycle of mobile games tends to be short.

Digitalization of content is another reason IP has become important

Digitalization of content production will turn entertainment industry increasingly IP-focused in the long run. Already a lot of special effects in movies has made game and movie indistinguishable, which leads to shortening of the development cycle of console and PC client games, making convergence possible.

However, what sells in game and movie is never special effects, it is storyline, or plot, or gameplay. Movie is a condensed capsule while game is an elongated life. But what does users look for in entertainment? Most of the time condensed form of fun. But how to achieve it? There are three ways: (1) a superior human-designed immersion experience broadcasted over a large audience (movie), (2) a human-to-human immersion experience interacted one-to-one (PvP game), (2) a machine-designed immersion experience interacted one-to-one (PvE game). In the end, entertainment is like playing a chess. We look for intellectually stimulating counterparts that can achieve real-life accomplishments through common life emotions. The problem is cheating human brain is an unscalable task. An elite team can deposit a year of their time to produce a cheating

Mobile game helped a lot to monetize intellectual properties (IP) because of its short development cycle.

Convergence is profit maximization at the expense of product quality. It is a cost optimization, which in the realm of creativity industry, is an afterthought after revenues

Convergence of IP must first convergent on tools, methods and rules. This has happened with the advent of digital technology but digital alone is not enough

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program of 90-120 minutes aided by visual technology. They then use broadcasting technology to reproduce it millions to billions of times. This is film making. The ratio of time from production to showing is 5000:1, meaning a professionally-trained production team spends 5000 hours to make a movie of 1 hour of time. Not to mention that not a lot of people actually made it to the professional grade.

That's why we have games. But even in a game the-machine-assisted interactive content can be exhausted quite quickly after each release of expansion packs. This is why game design must resort to Person-vs-Person (PvP) to fill the gap. But the entertainment quality of a PvP scenario is highly uncertain (and unreproducible). Here enters e-sports, which is to distill high quality PvP sessions to watchable entertainment pieces (condensed form of fun). For the same reason, the success of VR/AR rests on creating new ways of storytelling to create condensed form of fun.

In entertainment human looks for condensed form of fun. Machine learning can prolong the product life of entertainment

Exhibit 25. Top three grossing games in each of the game genres and those owned by Tencent

Genre	PC Client+Web Game	Mobile
Casual	<u>QQ Tang (QQ 堂)</u> , PaoPao Tang (泡泡堂), TanTan Tang (弹弹堂)	FishingJoy (捕鱼达人), Plants vs. Zombies (植物大战僵尸), Angry Birds (愤怒的小鸟)
Chess & Card	<u>QQ Game Platform (腾讯游戏大厅)</u> , OurGame (联众) Platform,, Boyaa (博雅)	<u>QQ Happy Beat the Landlord (快乐斗地主)</u> , Ourgame Beat the Landlord, Boyaa Beat the Landlord
Parkour (跑酷)		<u>Everlasting Parkour (天天酷跑)</u> , Temple Run (神庙逃亡), Subway Surfers (地铁跑酷)
Match Puzzle		<u>Funfest (开心消消乐)</u> , Pop Star (消灭星星)
Real Time Strategy (RTS)	StarCraft (星际争霸), Age of Empire (帝国时代), Warcraft (魔兽争霸)	
Simulation Game (SLG)	SiegeLord (攻城略地), The Sword of Archangel, Dragon Blade (龙之刃)	Clash of Clan (部落战争), Boom Beach (海岛奇兵), Clash of King (皇室战争)
Construction and management	<u>QQ Farm (QQ 农场)</u> , Moore Manor, Obi Island	We Farm (开心农场), Hay Day (卡通农场), Big Tycoon (大富豪)
ARPG	World of Warcraft (魔兽世界), Zhengtu (征途), Legend of Mir (传奇)	<u>Legend Of Mir Mobile (传奇手游版)</u> , We MU (全民奇迹), 6L (六龙争霸)
Turn based MMORPG	Fantasy Westward Journey (梦幻西游), Westward Journey (大话西游)	FWWJ Mobile (梦幻西游手游版), WWJ Mobile (大话西游手游版)
Card		All Star Heroes (刀塔传奇), Junior Three Kingdom (少年三国志), Let Go Three Kingdoms (放开那三国)
Trading Card Game (TCG)	Hearthstone (炉石传说), Magic: The Gathering	Hearthstone (炉石传说)
Multiplayer Online Battle Arena (MOBA)	<u>League of Legends (英雄联盟)</u> , DOTA 2, Heroes of the Storm (风暴英雄)	Legend of Kings, Fight for Freedom (自由之战)
Shooting	<u>CrossFire (穿越火线)</u> , <u>Assault Fire (逆战)</u> , Counter Strike Online (反恐精英)	<u>Cross Fire Mobile (穿越火线手机版)</u> , <u>We Shoot (逆战手机版)</u> , Crisis Action (全民枪战)
Fly & shoot		<u>We Fly (全民飞机大战)</u> , Legend of Galaxy (银河传说)
Speed	<u>QQ Speed (QQ 飞车)</u> , R2 Beat	<u>Everlasting Car Race (天天飞车)</u>
Fighting Game (FTG)	<u>Dungeons & Fighters (地下城与勇士)</u>	<u>Naturo Mobile (火影忍者)</u> , Everlasting Fighting (天天格斗), <u>TTXD (天天炫斗)</u>
Board Game	San Guo Sha (三国杀)	San Guo Sha (三国杀), Ying Xiong Sha (英雄杀)
Animation Comic Game (ACG)	Aura Kingdom (幻想神域)	Warship Girls (战舰少女))
Sports	<u>NBA2K OL</u> , FIFA OL3, Wild Football	ZCFY (中超风云), Tencent Billiards
Music	<u>QQ X5 (QQ 绚舞)</u> , Audition I&II (劲舞团)	Rhythm Master (节奏大师)

Source: BLRI. Underlined are Tencent games (as of 4/1/2016)

This is why we believe movie making will have its life for years to come. Users are not looking for carbon copy of their mundane life. They want to live alternate lives without actually spending the

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time. Another area we see breakthrough improvement is machine-learning-assisted game design. The success of AlphaGo (The machine Go chess player) over human champion Lee Seedol suggests to us that a think machine might help to design interactive games soon.

Tencent's position in the days of IP has strengthened, not weakened

Tencent is no stranger to the IP-centric world. In 2015 we estimate Tencent had 42% market share in the online game market. Tencent achieved this success not only because it is the biggest distribution channel for online games but also because it has first class in-house development capability.

Exhibit 25 shows the top grossing games in each of the game genres. Among the twenty game genres Tencent has top grossing IP in twelve, in line with its 42% market share. In pursuit of its dominance Tencent has acquired a rich depository of IP assets that can be cross fertilized.

Exhibit 26 shows the recent cases of IP fertilization, or Convergence. It shows movie and game have higher level of monetization than Literature and Animation. From a commercial point of view, the most successful cases of cross fertilization (convergence) happen between Game-to-game, Literature-to-X and Animation-to-X. IP fertilization can serve three purposes: (1) Screen low barrier IP for high barrier conversion; (2) Maximize revenue potential at the height of IP attention; (3) Prolong IP's shelf life.

Game and movie are two most important anchor of IP fertilization

Game-to-game, literature-to-X and Animation-to-X are three most productive IP fertilization routes

Exhibit 26. A glance of recent IP fertilization (convergence) cases

From	To	Literature	Animation	TV drama	Movie	PC/Web Game	Mobile Game
Literature	NA		ZTJ (择天记) Yuewen Group (阅 文集团)/Tencent, 2015	Nirvana in Fire (琅琊榜) Ruyi Films (儒意欣欣), 2015	The Ghouls (鬼吹灯) Wanda Film, Huayi Brother, Enlight Media, 2015	DPCQ (斗破苍穹) (9377&49you, 2012)	Journey of Flower (花千骨) (PPS, 2015)
Animation	Detective Conan Official Novel (侦探科南) (Shogakukan, 2012)	NA		The Legend of Qin (秦时明月) Chinese Entertainment (唐人影视), 2014	Happy Sheep Movie Series (喜羊羊系列) (2009-2015)	Chinese Hero (中华英雄) (Changyou, 2010)	Naruto Mobile (火影忍者) (Tencent, 2016)
TV drama	NA	N/A	N/A	NA	You Are My Sunshine (何以笙 箫默) LeVision Pictures (乐视影 业), 2015	Nirvana in Fire (琅琊榜) (37Wan, 2015)	Journey of Flower Mobile (花千骨) (PPS, 2015)
Movie	N/A	NA	Painted Skin 2 (画皮 2) (CCTV, 2013)	NA	NA	Dragon Blade (天将 雄师) 37Wan	Dragon Blade Mobile (天将 雄师) 37Wan
PC/Web Game	World of Warcraft Series (Blizzard, 2001-2016)	I'm MT (QCYH (七彩 映画), 2009)	The Legend of Sword and Fairy (仙剑奇侠) Chinese Ent'tmt, 2005)	World of Warcraft (Blizzard, 2016)	NA	NA	Fantasy Westward Journey Mobile (NetEase, 2015)
Mobile Game	N/A	Heroes don't BiBi (英雄别闹) Crius Anime, 2015	N/A	N/A	N/A	N/A	NA

Source: BLRI (as of 4/1/2016)

Game is still the linchpin in IP fertilization

In our view, game and movie are two anchors of IP fertilization that can utilize all three purposes of screen, maximize and prolong. This is not only because their abilities to generate revenues but also their relatively high entry barriers. Technologically speaking, game and movie which utilize

IP fertilization can screen content, maximize revenue potential and prolong IP shelf lives

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human's motor skills and hearing ability have higher level of real life emulation than Animation, which in turn has deeper immersion than Literature and Manga which only uses human's visual ability. Economically, movie theatre has higher entry barrier than game distribution.

Between game and movie, game still has far greater revenue generating ability than movie. In 2015, China's online game market reached Rmb140bn. Movie market only had Rmb44bn. Both markets have huge underground segments. For game it was pirated server (私服), BOT (外挂) and illegal gambling. For movie it was pirated video and downloads. If we use US as a benchmark, the market size between game and movie is roughly 2:1 in 2015, versus China's 3.2:1. In fact, movie box office *is* growing at faster clip than game revenues in recent years. The importance of movie is growing and with the advent of VR (Virtual Reality) and AR (Augmented Reality) technologies, it is possible that movie and game can merge into a new entertainment form.

Game market is 3.2x of movie box office in China and 2x in US

AR/VR's chance as general computing platform is still an unknown

At this point it appears early hardware opportunities mainly rests with global vendors because only they have the supply chain prowess to drive the hardware price down to reach targeted penetrations. In the software and content war that will follow, whether AR/VR will be a general purpose machine holds importance. To solve the chicken-egg problem, general purpose machines like PC and smartphones use an open ecosystem to foster the participation of content contributors. General purpose machines are also made as versatile as possible so as to maximize the potential end use. However, at this stage, AR/VR look more like special purpose machines for game and entertainment.

AR/VR could be a new computing platform because it utilizes new user interface mechanisms

AR/VR could be a general computing platform: user interface is key

An AR/VR hardware share many components with PC and smartphones, but with the addition of 3D lenses, nano-projectors and position tracking systems. In other words, the main difference is user interface. The question is whether AR/VR's user interface warrants the establishing of a new general purpose machine interface. If it does, it will change the course of the content industry to remake its content for AR/VR. The benefit must outweigh billions of dollars of human effort and production investments. If it doesn't the content will be slow in coming. Without software and content, AR/VR will be white elephants.

AR/VR does not provide just one unique consumer benefit to link human with machine. It is a comprehensive departure from the screen technology of all past computing devices.

For smartphones the consumer benefit is mobility, for PC's it was productivity and for TV's it was reality immersion. Form factors that do not provide unique value, like desktop PC and small size TV eventually fade out. Question is what unique consumer benefit does the AR/VR interface provide?

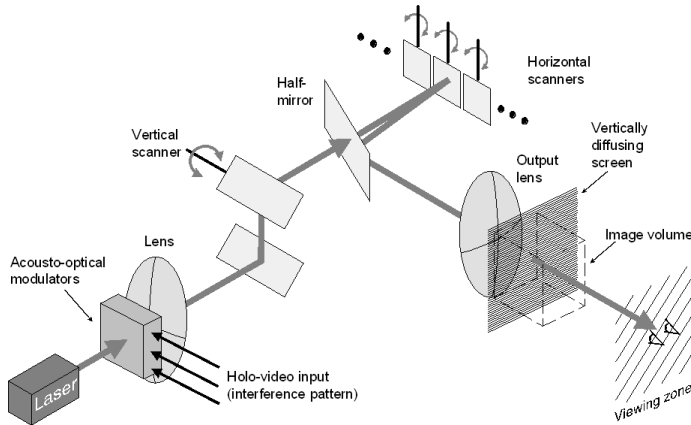
In our view, the answer is AR/VR provide all three consumer benefits of smartphone, PC and TV and more. AR/VR fundamentally changed the viewing mechanism. All past output devices are screen based. But AR/VR are projection-based. This means AR/VR is a fundamentally different I/O interface between machine and human. As a result, AR/VR will need to satisfy all three consumer benefits of mobility, productivity and reality immersion to be successful.

Exhibit 27-29 shows the optical mechanism of Microsoft's HoloLens and Facebook's Oculus Rift. HoloLens and other AR technology use Holography (全息影像) to record and reconstruct a light field of which the boundary is the displayed image. Holography makes holograms like the virtual meeting conducted by Jedi Council in the movie Star Wars.

AR/VR calls for completely different content display and human-machine interaction philosophies.

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Exhibit 27. Mechanism of Hologram (全息技术) - recording



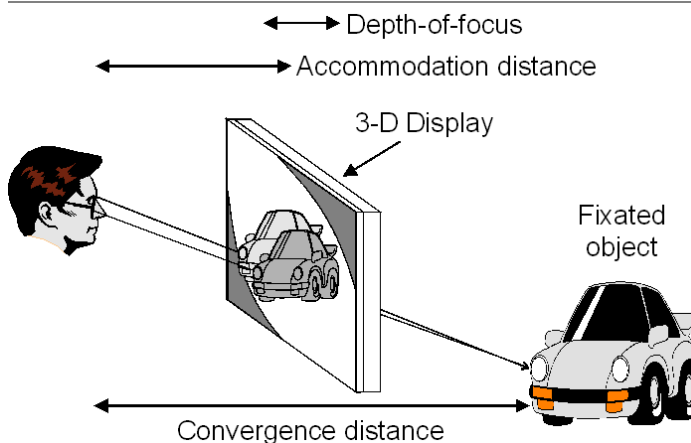
Source: Wiki (As of 3/21/2016)

Exhibit 28. Hologram depicted in movie "Return of the Jedi"



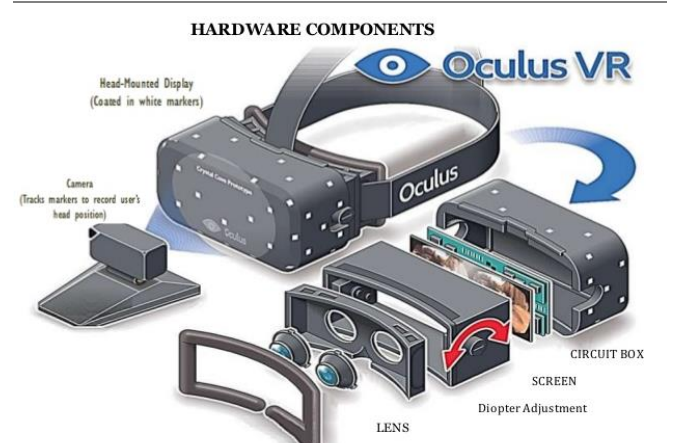
Source: Return of Jedi, BLRI (as of 3/21/2016)

Exhibit 29. Mechanism of Stereographic Display (立体摄影)



Source: Wiki (As of 3/21/2016)

Exhibit 30. Head Mounted Display (HMD) uses Stereography



Source: Wiki (as of 3/21/2016)

A general computing platform is detrimental to Tencent's dominance

PC's migration to mobile wasn't a great challenge to Tencent because mobile is built into Tencent's DNA. In 2001 mobile was 77% of Tencent's revenues and at the time of its IPO (2004) mobile was still 56% of its revenues. Further, social relationship has largely transcended the migration from featured phones to smartphones. Lastly, Weixin not only allowed Tencent to keep its market share, but expanded its footprint and demographics.

If AR/VR becomes a new general computing platform, Tencent may not be so lucky to transfer all its social relationships to the new platform. This is indeed a risk Tencent must manage. But still we consider that:

- **Time is on Tencent's side:** Technologically wise we believe it will take very long for AR/VR to emerge as a general computing platform. In particular we view AR, or AR/VR hybrid as having a more hopeful chance to do so than VR. We doubt VR can reach general purpose because of VR's isolation experience, which makes some viewing experiences highly differentiated but others impractical. Historically special purpose machine had a poor track

If AR/VR become a general computing platform quickly, Tencent might lose its user base.

VR's isolation experience is detrimental to its chance to be a general computing platform.

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record in achieving high adoption in China due to: (1) affordability to mass market, (2) possibility of it being replaced by later versions of general purpose machines;

- **Globalization is Tencent's strength:** Over the past four decades machine (hardware) has shown itself to be a global business while people (software) to be a local business. Chinese companies excelled in software and content but only recently did Huawei captured globally attentions. At this point it is difficult to envision the role Chinese manufacturing will play in the AR/VR roadmap globally but likely this role will be very small initially. But if history is indication Chinese companies have a bigger chance to play a big role in software. Tencent is one of the few Chinese companies who can have an impact globally hence it can participate in AR/VR earlier than its Chinese peers;
- **Interactive game is still closer than most contents to AR/VR:** A major hurdle for the adoption of AR/VR in the developed countries is the content's IP. The owner of existing IP's has the option of sitting on IP assets waiting to take control of AR/VR when it matures. This will hinder the startups' willingness to invest. While facing equally challenging affordability issues, the developing countries might see more trial-outs as existing IP's are less protected. We believe this scenario benefits large corporation more than small companies in developing countries. Game as an interactive entertainment form is closer to AR/VR content than earlier broadcasting or print entertainment forms. Companies with proven ability to orchestrating a content provision platform, like Tencent, has strong advantages, in our view.

Chinese companies' strength in Internet has historically been application and content, not hardware and OS.

E-sport migration from PC to mobile provide near term support

We are positive on Tencent's long term performance in interactive entertainment for the following reasons:

- **Traffic front end:** Tencent owns powerful social network and distribution channels on PC and mobile, including PC QQ, Weixin, mobile QQ and MyApp (应用宝). Tencent's offline Internet café network has 20K outlets;
- **Product and user education mid-end:** Tencent has comprehensive and workable methodology in (1) user strategy, from light to heavy games, (2) product roadmap of top down segmented approach, and (3) testing methodology of exhaustive product testing protocols;
- **Global IP footprint:** Tencent has the most global-minded business development team. Through investments, Tencent spreads its antenna to game development studios worldwide. To date, Tencent has invested or partnered with Activision Blizzard (CODOL), Epic Game, NetMarble, Nexon and a range of small studios. In China Tencent has invested in Happy Elements (乐元素), Yinhan (银汉), Longtu (中清龙图), Sincetimes (华清飞扬), iDreamsky (乐逗游戏), Hoolai (胡莱游戏), Elex-Tech (智明星通) and Good Games (谷得游戏), many of which has since listed in A-share or acquired by A-share companies.

Tencent has bought up the entire game IP value chain

Tencent's PC-based e-sports game could be a bonanza on mobile

In the past we have noticed that big-IP PC client games tend to be money spinners when they are converted to mobile. Examples include NetEase's *Fantasy Westward Journey (FWWJ)*, *Westward Journey II (WWJ)*; Shanda's *Legend of Mir (传奇)* and WebZen/KingNet's *MU (奇迹)*. The questions is: can Tencent's e-sports/RPG blockbusters like *Crossfire (CF, 穿越火线)*, *League of Legend (LOL, 英雄联盟)* and *Dungeons & Fighters (DNF, 地下城与勇士)* accomplish the same?

Tencent has double lock for success in 2016: converting its e-sports game to mobile, and distribute mobile version of third party's key games

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We think the chance is very high because Tencent is known to have the patience, methodology and resource to modify a game to its perfection. Certainly, Tencent's blockbuster e-sports game are licensed games which might hinder its ability to redevelop. But Tencent has acquired 100% of Riot Game, developer of *LOL* in 4Q15. Tencent has made so many modification and optimizations of *Crossfire*'s PC version that it should be viewed as Tencent in-house game. Nexon also announced that it licensed *DNF*'s mobile rights to Tencent.

Competitors in the PC era has flocked to license mobile game to Tencent

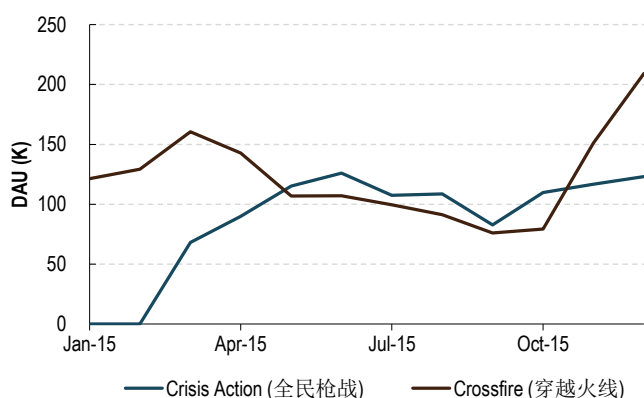
Perhaps the most demonstrating the trust the market placed on Tencent on its ability as a publishing platform is the recent line up of 2016 pipeline. Competitors in the PC era all put their mobile title to Tencent for publishing. This include Giant Interactive's *ZT* (征途), Changyou's *TLBB* (天龙八部), Perfect World's *ZX* (诛仙), Kingsoft's *JX3* (剑侠情缘 3) and Shanda's *WOOL* (传奇世界). NetEase's success awakened the market that PC MMOG can be good mobile money spinners. All MMOG developers now flock to mobile. This effectively give Tencent the second safety lock on its 2016 game performance.

Lastly, the market has shown in mobile game IP is more important than timing. Official version has shown to surpass copycat versions in the past. Although Qihoo and The9 licensed *Crossfire 2*, *CF2* is a totally different game from *CF*. In the market for example *CF* quickly surpassed competitor *Crisis Action* (*CA*) by Herio Interactive in DAU in 4Q15 (Exhibit 31). To make *DNF* and *LOL* available on mobile has no obstacles ahead. We believe both games will be on mobile in 2016 and *CF* will reach new heights.

Can e-sports game be made to mobile with the same level of revenue?

A more relevant question is whether e-sports games can be successfully made into mobile. There are three challenges: (1) e-sports game tends to emphasize on game manoeuvring. Touch screen does not have as fast response time as a mouse; (2) e-sports game tends to have low monetization levels which means on mobile it must amass a bigger traffic than PC in order to be successful; (3) mobile game's life cycle tends to be short while e-sports players need to invest long time of training and learning to be competitive. They may not be willing to spend the time to learn mobile.

Exhibit 31. *CF* has overtaken *CA* in DAU



Source: iResearch (As of 3/21/2016)

Exhibit 32. Tencent's game distribution channels

Channel	Distribution capability
PC QQ	MAU 853mn (4Q15)
QQ Internet Café Alliance	20K active QQ Internet Café Alliance members
Weixin	MAU 697mn (4Q15)
Mobile QQ	MAU 642mn (4Q15)
MyApp	MAU 156mn (4Q15)

Source: Tencent, QuestMobile (2016/2/6)

That said, we take the view that given enough optimizations, PC-based e-sports games can all be made into mobile-based. Simpler e-sports games like shooting game already saw blockbuster titles like *Crisis Action* (全民枪战) and *Crossfire Mobile*. More manoeuver-driven games like *Dungeons & Fighters* (*DNF*) and *League of Legends* (*LOL*) could see long time of redevelopment.

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PC client games stagnate while mobile games reach its peak

Globally game developers spend less time on developing PC games, which will lead to the decline of the overall quality. Overtime, major PC games will enter late stages of their life cycles. Some of PC client games aren't suitable for making into mobile games, which means different gameplay must be introduced under the same IP. For example, Blizzard's make of Hearthstone is a totally different genre from its PC predecessor Warcraft.

There are difficulties in making PC e-sports games into mobile. But we are positive on the innovation by mobile game entrepreneurs

When making projections of Tencent's game revenues, we follow the methodology of product-driven for PC and scale-driven for mobile games. We forecast:

- PC client game will maintain stable. We forecast 2015/16 PC client game revenue to be Rmb35.1 and 36.8bn, respectively, representing growth of 6.7% and 4.8%;
- Mobile game will continue to grow but Tencent's market share will decline a bit. We estimate 2015/16 mobile game revenues to be Rmb19.9 and 27.2bn, respectively, representing growth of 69% and 36%;

Together we estimate Tencent's 2015/16 online game revenue to be Rmb55.1bn and 64bn, respectively, representing growth of 23% and 16% YoY.

Bottom up analysis of Tencent's game portfolio

In performing our bottom up analysis, we stick to the methodology of product analysis for PC client game and traffic analysis for mobile game. We reach the conclusion that PC client games should have stable single digit growth and mobile game should have low double digit growth in 2016-17.

PC client game: stable performance ahead

After more than twenty years of development, PC client game has entered a product-centric era. Tencent is one of the couple PC client game developers remaining who can shoulder PC client game's long development cycles and investments. We estimate Tencent's three major PC client game titles: *LOL*, *CF* and *DNF* contributed 60-70% of its PC client game revenues of Rm36bn. As a result, we feel it necessary to analyze each of these three titles individually.

Tencent should have high single digit growth in PC client and low double digit growth in mobile.

Exhibit 33. LOL 2015 a glimpse of new expacks

Time	Update type	Description
2015.1	Map, Model, Game balance	New map "Summoners Rift" (召唤师峡谷)
2015.2	Champions, Skin	Kayle (防爆天使凯尔) Skin, Tristana (麦林炮手崔斯塔娜) remake,
2015.3	Champions, Skin	DJ Sona (琴瑟仙女娑娜) Skin, Bard (星界游神巴德)
2015.4	Gameplay update	Unlimited fire power mode
2015.5	Champion	Ryze (流浪法师瑞兹), Ahri (九尾妖狐阿狸) remake, Bright Skin
2015.6	Champion, Gameplay update	Ekko
2015.7	Champion, Game interface update	Tahm Kench (五星大厨塔姆)
2015.8	Champion	Gangplanck (海洋之灾刚普朗克), Fiora (无双剑姬菲奥娜), Teemo (迅捷斥候提莫) remake
2015.9	Champion, Skin	Four Year Anniversary Skin, Skarner (水晶先锋斯卡纳) remake
2015.10	Champion	Kindred (永恒猎手千珏)
2015.11	Game balance	New Summon system
2015.12	Champion	Taric, Poppy (钢铁大使波比) remake

Source: LOL Official Site (2016/2/6)

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League of Legends (英雄联盟) or LOL

As the world the largest PC client game, LOL is still registering 20% YoY growth in 2015.

Main reasons for LOL's stellar performance are the following:

- Developer Riot Games continued to roll out new expansion packs (expacks). In 2015 Riot Game achieved monthly release of expacks in gameplay, heros, skins and game balance (Exhibit 33). This effectively stimulated game's active level;
- Operator Tencent maintained frequent game contests schedules nationwide (Exhibit 34);
- Competing games had lacklustre performance comparing to *LOL* (Exhibit 35)

Frequent expacks and contests drove LOL performance in 2015

Exhibit 34. LOL major contests at a glance

Geography	Type	Organizer	Description
China	Official Championship Series	Tencent	Tencent organizes multilevel championships, including café contest, college contest, city championships, online, semi-professional First Division, professional LOL Pro League (LPL) Championships
China	3P Contest	3 rd party	World Cyber Arena (WCA)
Global	Official Championship Series	Riot Games	LOL Championship Series (LCS) in North America, Online Game Net (OGN) in S. Korea, LOL World Championship S1-S6

Source: LOL Official Site (2016/2/6)

Exhibit 35. LOL major competition at a glance

Platform	Genres	Title	Why they are not successful
PC	MOBA	Heroer of the Storm(风暴英雄), DOTA2, Heroes of Newerth (超神英雄)	HOS too simple, DOTA2 too difficult
PC	Other e-sports games like FPS, TCG	Crossfire (穿越火线), Counter Strike (反恐精英), Hearth Stone(炉石传说), World of Tank (坦克世界), Overwatch (守望先锋)	Strong social elements embedded in LOL makes other e-sports game hard to succeed
Mobile	Mobile e-sports games	PvP (王者荣耀), CF Mobile(穿越火线: 枪战王者)	Mobile e-sports game cannot replicate the player experience on PC

Source: LOL Official Site (2016/2/6)

We are optimistic on *LOL*'s near term growth. Before the emergence of strong competitor games *LOL*'s active user level and revenue should remain stable. Judging from the games in the pipeline worldwide, there hasn't emerged a capable competitor yet. Blizzard Entertainment is scheduled to launch *Overwatch* (守望先锋) which was looked upon to provide some much needed competition but so far it appears it is not up to the task. *Overwatch* will adopt a pay-to-play model which will limit its user level, in our view. We also believe NetEase will shift its strategy focus to mobile games, which will reduce *Overwatch*'s marketing fire power at its launch.

Overwatch may not be a strong competitor to LOL.

Comparing to early genres of online games (like MMOG), *LOL*'s monetization scheme does not alter the combat power of each character. This leads to low monetization level but longer sustainability of the game. *LOL* sells champions to help the player combat, and skins to show off. We estimate monthly ARPAPA is about Rmb20-25, about one third the level of *CF*, one eighth the level of *DNF*. Because skins are decorative in nature, they can be sold repeatedly without impacting the game balance. There is strong seasonal pattern of *LOL*, as Chinese New Year and

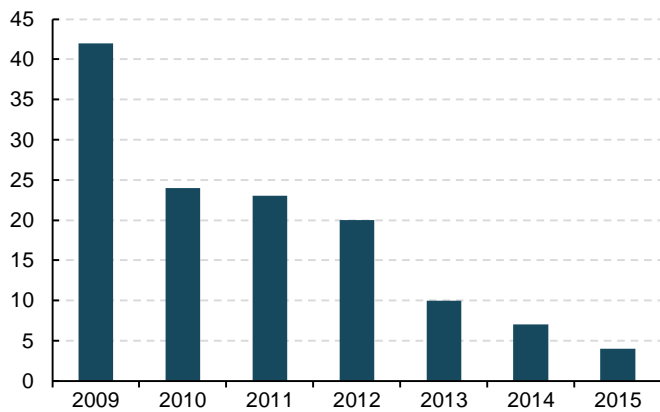
Tencent likes to flank its flagship game with auxiliary games. Some are successful but none can replace the flagship yet.

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Summer Holidays tend to have purchase peaks and promotional events. Lastly, Tencent has been well prepared to manage the shelf life of *LOL*. Like it did to *CF*, Tencent has launched two sister version of *LOL: Heroes of Newerth (HON)* and *PvP (王者荣耀)*.

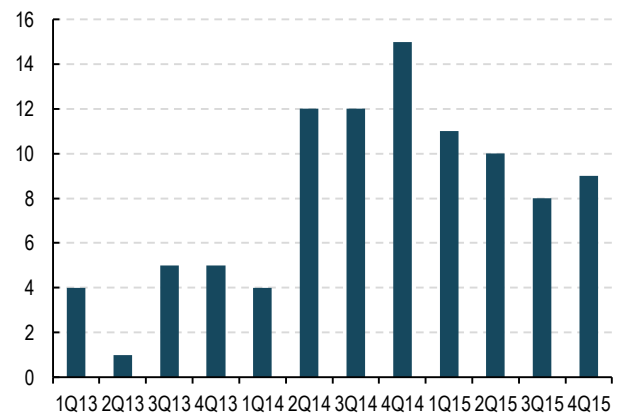
Besides risks of potential competitors, another risk is that *Champions* are becoming increasingly indistinguishable. Riot's emphasis has been placed on remaking *Champions*. One way or another, it has become increasingly difficult to maintain the level of excitement for players (Exhibit 36).

Exhibit 36. Number of new champions released by LOL



Source: League of Legend Official Site (As of 2016/2/6)

Exhibit 37. Number of mobile games published by Tencent



Source: Appstore (2016/2/6)

Players flock to the best game in absolute, not the second best in genre

Both *Crossfire* and *DNF* have been operating for more than seven years. After being impacted by *LOL* and mobile games, these two games still maintained healthy traffic levels. MAU declined 13% and 8% YoY, respectively. Tencent and game developers maintained frequent content updates. Various e-sports contests also served to prolong the life cycles of these two e-sports games.

The biggest risk to Tencent is still the next big thing in online game falls under someone else.

Exhibit 38. Graphic quality of Crossfire (CF) is poor



Source: Crossfire (as of 4/1/2016)

Exhibit 39. Graphic quality of Call of Duty Online is great



Source: Call of Duty Online (as of 4/1/2016)

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It is worth to point out that although Tencent has been trying to segment the gamers in hope to retain the gamers as the main title aging, the outcome has not been spectacular. Auxiliary titles in hope to replace *Crossfire*, such as *TPS* (枪神记), *Assault Fire* (逆战), *Call of Duty Online* (使命召唤) all have failed. On the contrary, *CF* players flocked to *LOL*. This means players are not loyal to any particular genre of games, but want the best game experience. The advantage Tencent enjoys is that social relationship can quickly ferment the interest levels of good game titles and achieve a viral effect to make the good game a success. But without the seed of a sufficiently differentiated game experience, players tend to stay at where they are.

Social is a catalyst, but cannot do what a product does

As Exhibit 38 and 39 show, although *Call of Duty Online (CODOL)* had much finer graphic quality than *Crossfire*, it was not able to divert gamers from *CF* to *CODOL*.

Other notable Tencent PC client games in the pipeline includes *War Thunder* (战争雷霆), a Russian developed games aimed at challenging Kong Zhong's *World of Tank* (坦克世界). It has garnered some praise worldwide but has relatively small nice in China, in our view.

Tencent has prepared three MOBA games to diversify the *LOL* gamer base: *SMITE* (神之浩劫) by US-based Hi-Rez Studio; *Orcs Must Die Unchained* (兽人必须死) by US-based Robot Entertainment and *Heroes of Newerth* (超神英雄) by US-based S2 Games. These games have some levels of innovation on MOBA (Multiplayer Online Battle Arena) and TOBA (Tower Defense Online Battle Arena) but we view then unlikely to threat *LOL*. *ArcheAge* (上古世纪) is typical Korea MMOG that delivers stunning graphics and grand worldviews. But like its peer game *Blade & Soul* (剑灵), Korea MMOG hasn't done so well in China lately. *Monster Hunter Online* (怪物猎人) is a redevelopment of an old Capcom console title that has dragged for more than five years in the making. We believe these five years of delay has cost Tencent a large chunk of targeted users as they growing older. Now the IP has become more of a niche. *T7* (刀锋铁骑) is a new game genre similar to Paradox Interactive's 2011 title *Mount & Blade* which will compete with NetEase's *Z* (战意). But games have console class graphics but are likely niche products.

Before the March 25 release, Tenent's pipeline is second to none

Mobile games: strong MMOG alleviated transition risk of e-sports

First, we believe mobile game as a whole shall experience slowdowns in 2016 and beyond. We forecast mobile game to grow 87%, 50% and 30% in 2015-17. As the market slows, we expect mobile game to resemble more like PC client games in which gamers will look for superior game contents as they becoming more sophisticated.

We believe Tencent Game's market share risk in 2016 is the following:

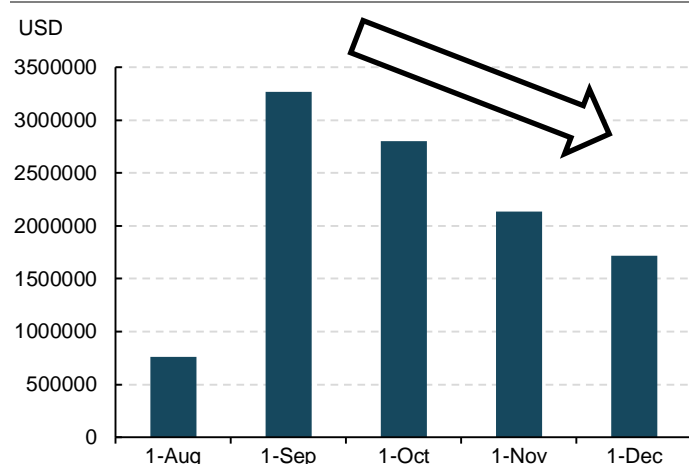
- **Transitioning PC client e-sports games to mobile could take some time:** PC client e-sports games emphasizes on manoeuvring which is not easily replicable on mobile. We expect Tencent to optimize gamer experience to eventually make it right but this process will prolong the game launch time table, in our view;
- **Distribution capability has peaked out:** Since 2014 app distribution on mobile has followed the trend of decentralization. Game quality is becoming more and more important to a game's success;

Tencent knows how to generate traffic but still doesn't know how to generate revenue in heavy games.

Weakness in heavy games: Most of Tencent's MMOG games enjoyed rapid ascendance in traffic, thanks to Tencent's platform support. But usually they peaked out after two months (Exhibit 37, 40-43). This phenomenon has happened in PC client game as well, showing Tencent's development in heavy games is still not at the state of the art.

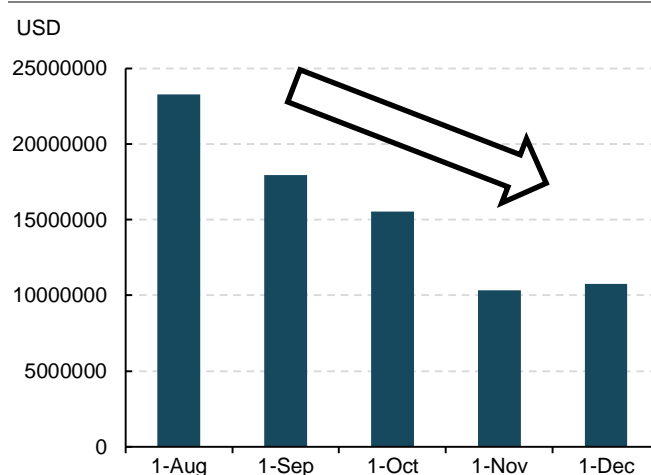
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Exhibit 40. Appstore revenue estimate of MOBA (全民超神)



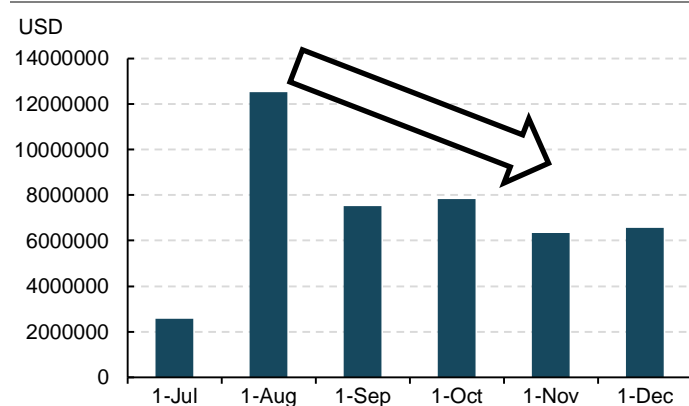
Source: App Annie (as of 4/1/2016)

Exhibit 41. Appstore revenue estimate of Mir 3 (热血传奇)



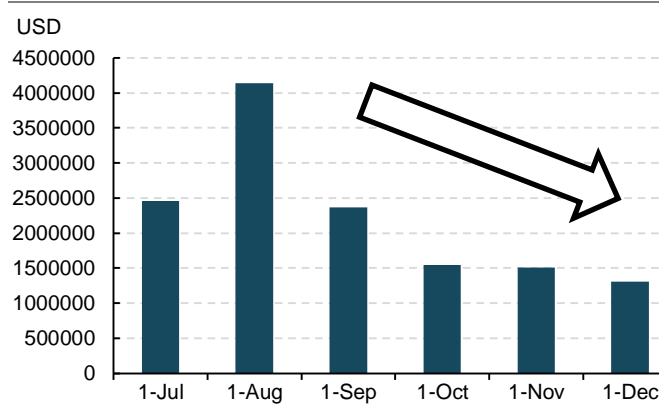
Source: App Annie (as of 4/1/2016)

Exhibit 42. Appstore revenue estimate of FoF (拳皇 98)



Source: App Annie (as of 4/1/2016)

Exhibit 43. Appstore revenue estimate of 9LZ (九龙战)



Source: App Annie (as of 4/1/2016)

Licensed MMOG pipeline mitigated the transition risk

To make up its weakness in heavy games Tencent released a spectacular mobile game pipeline on March 25, 2016. BLRI Game Analyst Shawn Yang released a comment on March 27. We believe two things happened:

- Following NetEase's success in *FWWJ* and *WWJ mobile*, most MMOG developers realized MMOG's can be refit into mobile without revenue cannibalizations;
- They entrust their best titles to Tencent take into consideration on the cost (development, marketing and distribution) and benefit.

Among the games announced, we look upon positively on Giant Interactive's *ZT (征途)* and Kingsoft's *JX (剑侠情缘)* Mobile because these two have distinctive game play, strong IP appeal and having original development team on board. We believe Changyou's New *TLBB (新天龙八部)* and Perfect World's *FZX (梦幻诛仙)* can achieve similar level of success as Tencent's own *YLOL (御龙在天)* and Shanda's *WOOOL (传奇世界)*.

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2016 will see most of the PC client classic games remade into mobile. The fact that Tencent will publish most of them mitigates Tencent's transitional risk for e-sports games.

Valuation and peer analysis

Our DCF assumes WACC of 10.7% current and 10.6% target with a terminal growth rate of 5%.

Our DCF is HK\$174.1 for the current capital structure (debt to capitalization ratio 5%) and 187.2 for the targeted capital structure (debt to capitalization ratio 10%). It is shown in Exhibit 44.

Exhibit 44. DCF valuation of Tencent

Year to Dec (RMB million)	2015E	2016E	2017E	2018E	2019E	2020E	2021E	2022E	2023E	2024E	Terminal
Core model assumptions											
Group revenue	102,863	142,467	178,901	216,706	254,451	289,649	327,739	363,212	394,953	422,952	422,952
EBIT	39,339	53,072	66,289	80,226	95,217	109,547	125,264	140,275	154,113	166,730	166,730
NOPAT	31,788	42,457	53,032	60,169	71,413	82,160	93,948	105,206	115,585	125,048	125,048
Capex, net	(12,852)	(17,096)	(23,257)	(30,339)	(38,168)	(40,551)	(42,606)	(43,585)	(43,445)	(42,295)	(42,295)
Depreciation & amortization	6,629	8,868	12,001	16,105	21,286	27,244	33,618	40,318	47,197	54,105	54,105
Change in working capital	58,765	(12,375)	57,394	(15,441)	59,286	(18,401)	62,647	(21,441)	58,311	(25,787)	(25,787)
Change in provisions	-	-	-	-	-	-	-	-	-	-	-
Free operating CF (FoCF)	84,329	21,854	99,169	30,494	113,817	50,452	147,606	80,498	177,648	111,070	111,070
Group revenue, y/y (%)		38.5%	25.6%	21.1%	17.4%	13.8%	13.2%	10.8%	8.7%	7.1%	7.1%
EBIT margin (%)	38.2%	37.3%	37.1%	37.0%	37.4%	37.8%	38.2%	38.6%	39.0%	39.4%	39.4%
Working-capital intensity (%)	3.8	4.7	5.5	6.3	7.2	8.2	9.0	9.9	9.1	8.5	8.5
Fixed-asset intensity (%)	0.5	0.5	0.7	0.7	0.6	0.6	0.5	0.5	0.4	0.4	0.4
Net capex as a % of revenue	12.5	12.0	13.0	14.0	15.0	14.0	13.0	12.0	11.0	10.0	10.0
Depreciation as a % of Capex	51.6	51.9	51.6	53.1	55.8	67.2	78.9	92.5	108.6	127.9	127.9
Normalised tax rate (%)	19%	20%	20%	25%	25%	25%	25%	25%	25%	25%	25%
Free CF / CE (%)		294.0	902.2	201.1	571.4	199.1	473.8	214.0	472.3	295.3	295.3
DCF Parameters		Current	Target								
Interest-bearing liabilities as a % of EV		5%	10%	Common parameters							
WACC		10.6%	10.1%	Terminal FCF growth				4.50%			
NPV of FoCF	1,239,486	1,341,971	Risk-free rate				3.5%				
+ Net cash (debt), current			38,015								
- Pension prov. (Book value)			0	Beta				1.50			
- Minorities (Market value)			0								
+/- Other items			82,848								
= Equity value	1,360,348	1,462,834									
/ Number of shares			9,315								
= NPV per share (HK\$)	174.1	187.2									

Source: BLRI, Tencent (as of 3/31/2016)

Sensitivity analysis shows Tencent's DCF ranging from HK\$125 to HK\$567 based on different assumptions of WACC and terminal growth rates (Exhibit 45)

Valuation multiple is at historical mid-point

Exhibit 46 show the forward PE chart of Tencent. Tencent is trading at 12M forward PE of 31x, 30x ex-cash, which is at the mid-point of its historical range (Exhibit 46).

Tencent is 4th best performing stock among BLRI Index's sixty eight Chinese Internet stocks, after New Oriental (EDU US, NR), Tiange Interactive (1980 HK, NR), NetQin (NQ US, NR). Tencent outperformed many of its peers because the sector is trading near trough valuations following a dismal 1Q16.

Tencent is trading at the mid-point of historical PE range, despite the fact that whole sector is trading near trough valuation

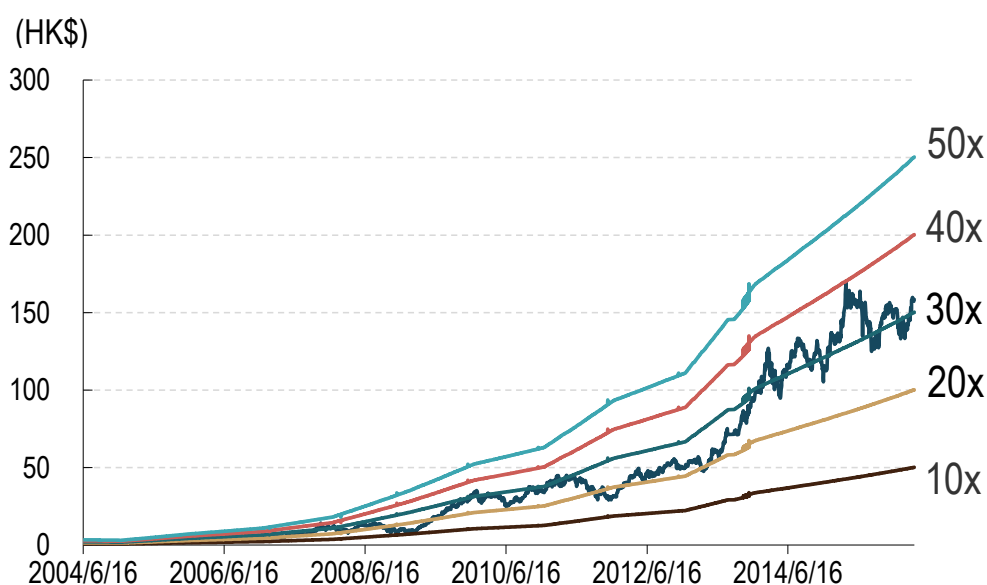
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Exhibit 45. Tencent DCF sensitivity analysis

	Terminal growth									
	2.5%	3.0%	3.5%	4.0%	4.5%	5.0%	5.5%	6.0%	6.5%	
8.1%	212.2	224.8	240.1	259.2	291.2	325.8	374.1	446.6	567.5	
8.6%	198.6	209.1	221.8	237.3	256.6	281.5	314.6	361.0	430.7	
9.1%	183.9	192.5	196.4	208.0	222.3	240.2	263.1	293.7	336.6	
9.6%	166.3	173.1	181.0	190.4	201.6	215.3	232.5	254.5	283.9	
WACC										
10.1%	155.9	161.5	168.0	175.6	187.2	195.4	208.6	225.1	246.3	
10.6%	146.7	151.5	156.9	163.2	170.5	179.1	189.5	202.2	218.0	
11.1%	138.7	142.7	147.3	152.5	158.5	165.5	173.8	183.8	196.0	
11.6%	131.5	134.9	138.8	143.2	148.2	154.0	160.8	168.8	178.4	
12.1%	125.1	128.0	131.4	135.1	139.3	144.1	149.7	156.2	163.9	

Source: BLRI (as of 3/31/2016)

Exhibit 46. Forward PE chart of Tencent



Source: BLRI (as of 3/31/2016)

Tencent is reasonable comparing to global peers

Despite Tencent is trading at higher PE multiple, on a PEG basis (1.3x) Tencent is reasonable comparing to global peers in Game and Internet platforms (Exhibit 47). For example, Electronic Arts (EA US, NR) is trading at 1.4x PEG and Activision Blizzard (ATVI US, NR) is trading at 1.7x. Microsoft (MSFT US, NR), Alphabet (GOOG US, NR) and Facebook (FB US, NR) are trading at 1.9x, 1.4x and 1.3x respectively. Given most of Tencent's opportunities in the Three Mandates aren't yet materialized, its PEG ratio might be underrated in the long run.

Tencent's PEG might be understated because most of its Weixin related opportunities cannot be accurately quantified into revenue and profit yet.

Risk/reward analysis

Tencent is the 2nd highest excess return stock in the universe of China Internet because its years of trading is shorter than No.1 NetEase. On an annualized basis, Tencent ranks behind YY (YY US,

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NR) and VipShop (VIPS US, BUY, TP: US\$15.0). Tencent is the top return China Internet stock when one combined longevity of trading and annualized returns.

Tencent's biggest downside risk at this juncture, in our view, is being unable to monetize its mobile Internet infrastructure before being upset by a new hardware platform. This new hardware platform can be Internet of Things (IOT), AR/VR or Artificial Intelligence (AI). Even though Tencent can shift its ecosystem to the new hardware, its dominance may weaken. If the new hardware platform employs more machine-to-machine or human-to-machine but less human-to-human interactions, Tencent's dominance may also weaken. In our point of view, IOT, AR/VR and AI are still a decade away from mass adoptions. Any signs of acceleration before Tencent making meaningful headways in these three areas can result in a weakening of the BUY case.

Tencent is the only Chinese company who can sustainably penetrate developed markets as well as developing ones. Tencent's leadership in online game is already and truly a global leadership. Tencent's Weixin ecosystem is more complete domestically than internationally. We expect globalization to be a positive surprise for Tencent investors in the next decade.

The longevity of mobile smartphone as a general computing platform is where Tencent's risk can lie.

We expect globalization to bear fruit to Tencent in the coming decade.

Exhibit 47. Comparison table

		Price	Mkt Cap	CR Target	CR Rating	PE (consensus)			PEG	PS (consensus)			EV/EBITDA (consensus)	
2016/4/1		(Local)	(US\$m)	(Local)		2016E	2017E	2018E	2016E	2017E	2018E	2017E	2018E	
China online game sector														
Tencent	700 HK	158.5	188,841	183	BUY	29.7	23.3	19.7	1.3	7.2	6.0	17.1	14.1	
NetEase	NTES US	143.02	18,696	156	HOLD	13.8	12.2	10.6	1.1	2.9	2.4	9.2	8.0	
Kingsoft	3888 HK	17.86	2,953	NA	NR	18.3	13.7	9.3	0.5	1.6	1.2	6.1	4.0	
Sector			210,490			28.1	22.2	18.7	1.3	6.7	5.6	16.2	13.4	
Global online game sector														
Activision Blizzard	ATVI US	34.42	25,299	NA	NR	18.5	15.7	14.9	1.7	3.7	3.5	10.9	10.4	
Electronic Arts	EA US	65.92	20,390	NA	NR	20.5	18.0	15.3	1.4	4.2	4.0	11.0	9.8	
Nexon	3659 JP	1830	7,087	NA	NR	13.8	13.0	12.2	2.1	3.8	3.6	6.3	6.0	
NCSOFT	A036570 KR	256,000	4,723	NA	NR	20.0	15.6	13.4	0.9	4.6	4.4	9.6	8.5	
Zynga	ZNGA US	2.2	1,899	NA	NR	166.3	34.1	22.5	1.2	2.4	2.2	11.3	8.0	
Take-Two Int.	TTWO US	37.99	3,222	NA	NR	16.5	14.5	17.3	(7.4)	1.8	1.9	7.2	8.1	
Konami	9766 JP	3335	4,018	NA	NR	34.8	22.7	21.9	1.3	1.9	1.9	8.1	8.0	
Square Enix	9684 JP	2904	3,156	NA	NR	20.1	14.4	12.7	0.8	1.5	1.4	5.8	5.2	
Capcom	9697 JP	2716	1,360	NA	NR	18.8	14.9	14.1	1.2	1.8	1.7	6.9	6.7	
Sector			71,153			23.6	16.9	15.2	1.1	3.5	3.4	9.7	9.1	
Global platforms														
Alibaba	BABA US	78.73	197,803	84	BUY	29.1	23.4	18.7	1.0	9.9	7.8	19.2	15.3	
Baidu	BIDU US	190.33	65,866	201	BUY	27.3	20.5	15.4	0.8	4.3	3.5	14.6	10.8	
Facebook	FB US	116.06	340,444	NA	NR	37.3	27.5	20.7	1.3	10.0	7.8	15.7	11.4	
Google	GOOGL US	769.67	522,951	NA	NR	21.6	18.5	15.6	1.4	5.3	4.6	11.1	9.4	
Microsoft	MSFT US	55.57	439,520	NA	NR	19.9	18.3	16.2	1.9	4.5	4.2	10.4	9.4	
Softbank Group	9984 JP	5410	56,580	NA	NR	11.0	10.5	8.9	1.0	0.7	0.7	6.7	6.4	
Naver	A035420 KR	628000	15,893	NA	NR	26.3	20.4	17.7	1.7	4.3	3.8	11.7	10.4	
Sector			1,639,058			25.2	20.7	17.0	1.4	6.4	5.4	12.8	10.5	

Source: CapitalIQ, BLRI (as of 3/31/2016)

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Annual Income Statement

Fiscal year ending December 31

Exhibit 48. Annual income statement

(Rmb mn except per share)	F2013A	F2014A	F2015A	F2016E	F2017E	F2018E
Revenues	60,436	78,932	102,863	142,467	178,901	216,706
Value added services	44,985	63,310	80,669	103,214	125,002	146,291
Online games	31,965	44,756	56,587	72,680	87,202	100,631
Social network	13,020	18,554	24,082	30,535	37,800	45,660
Advertising	5,034	8,308	17,468	28,972	37,985	47,372
Brand	3,143	4,985	7,385	12,995	17,463	21,322
Performance	1,891	3,323	7,359	15,978	20,522	26,050
Others and e-commerce	10,417	7,314	4,726	10,281	15,914	23,043
Cost of Revenue	(27,778)	(30,873)	(41,631)	(61,114)	(78,878)	(95,546)
Gross Profit	32,658	48,059	61,232	81,354	100,024	121,160
Selling and Marketing	(5,696)	(7,797)	(7,993)	(10,558)	(13,541)	(15,969)
General and administrative	(9,988)	(14,155)	(16,825)	(21,903)	(25,440)	(30,383)
Share based compensation expense	(1,785)	(2,497)	(2,925)	(4,179)	(5,247)	(5,418)
Operating income/(loss) (GAAP)	16,974	26,107	36,414	48,893	61,042	74,808
Operating margin, GAAP	28%	33%	35%	34%	34%	35%
Operating income/(loss) (non-GAAP)	18,760	28,604	39,339	53,072	66,289	80,226
Operating margin, non-GAAP	31%	36%	38%	37%	37%	37%
Net Interest Income/(expense)	(84)	(1,182)	(1,750)	(2,135)	(2,403)	(2,708)
Other income/ (loss)	171	(347)	(2,342)	(5,203)	(4,483)	(2,241)
Earnings before Taxes	19,280	29,013	36,535	45,774	58,322	76,425
Tax benefit (expense)	(3,718)	(5,125)	(7,013)	(9,155)	(11,664)	(19,106)
Net Income/(loss) (GAAP)	15,562	23,888	29,522	36,619	46,657	57,319
Net margin, GAAP	25.7%	30.3%	28.7%	25.7%	26.1%	26.4%
Net income/(loss) (non-GAAP)	17,347	26,385	32,447	40,798	51,904	62,736
Net margin, non-GAAP	28.7%	33.4%	31.5%	28.6%	29.0%	28.9%
EPS, GAAP	1.66	2.54	3.10	3.83	4.89	6.01
EPS, non-GAAP	1.85	2.81	3.41	4.27	5.44	6.58
EBITDA	22,350	33,405	45,968	61,939	78,290	96,330

Source: Tencent, BLRI (as of 4/1/2016)

See the last page of the report for important disclosures

Annual Balance Sheet

Fiscal year ending December 31

Exhibit 49. Annual Balance Sheet

(Rmb mn)	F2013A	F2014A	F2015A	F2016E	F2017E	F2018E
CURRENT ASSETS						
Cash and cash equivalents	20,228	42,713	43,438	32,632	92,803	82,668
Restricted cash	4,131	9,174	54,731	65,677	78,813	94,575
Short-term investments	19,623	10,798	37,331	44,797	53,757	64,508
Accounts receivable, net of allowance	2,955	4,588	7,061	9,073	11,187	13,354
Inventories, net	1,384	244	222	0	0	0
Prepayments and other current assets	5,365	7,804	11,397	16,790	19,590	24,477
Total current assets	53,686	75,321	154,180	168,969	256,150	279,583
NON-CURRENT ASSETS						
Equity investments	12,515	13,277	44,339	48,773	53,650	59,015
Property, equipment and software, net	8,693	7,918	9,973	21,275	29,796	41,383
Investment property	0	268	292	292	292	292
Held-to-maturity Investments	11,420	4,831	3,674	4,409	5,291	6,349
Construction in progress	2,041	3,830	4,248	2,124	1,062	531
Intangible assets, net	4,103	9,304	13,439	13,882	16,617	19,264
Land use rights, net	871	751	2,293	2,293	2,293	2,293
Goodwill	11,995	54,135	66,945	70,292	73,807	77,497
Other assets	1,911	1,531	6,237	6,785	7,388	8,051
Total non-current assets	53,549	95,845	151,440	170,125	190,195	214,675
TOTAL ASSETS	107,235	171,166	305,620	339,094	446,345	494,258
LIABILITIES AND EQUITY						
CURRENT LIABILITIES						
Short-term bank loans	2,589	3,215	11,429	12,000	12,600	13,230
Accounts payable	6,680	8,683	15,700	20,094	26,104	29,856
Deferred revenues	11,841	16,153	21,122	21,033	29,942	29,430
Taxes payable	1,911	1,027	2,070	2,070	2,070	2,070
Accrued expenses and other current liabilities	10,246	19,123	70,199	60,924	108,313	96,686
Total current liabilities	33,267	48,201	120,520	116,121	179,029	171,273
Total non-current liabilities	15,505	39,007	60,312	56,592	53,442	49,662
Total liabilities	48,772	87,208	180,832	172,713	232,471	220,935
EQUITY						
Ordinary shares	0.2	0.2	0.2	0.2	0.2	0.2
Share premium	2,846	5,131	12,167	12,167	12,167	12,167
Capital reserves	(871)	(1,309)	(1,817)	(1,999)	(2,199)	(2,418)
Statutory reserves	3,746	2,129	9,673	16,920	17,310	18,952
Accumulated deficit	52,224	74,062	100,012	137,227	184,530	242,558
Total shareholders' equity	57,945	80,013	120,035	164,316	211,808	271,259
Minority interests in equity	518	2,111	2,065	2,065	2,065	2,065
TOTAL LIABILITIES AND EQUITY	107,235	171,166	306,818	339,094	446,345	494,259

Source: Tencent, BLRI (as of 4/1/2016)

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Annual Cash Flow Statement

Fiscal year ending December 31

Exhibit 50. Annual Cash Flow Statement

(Rmb mn)	F2013A	F2014A	F2015A	F2016E	F2017E	F2018E
Net income/(loss)	15,562	23,888	29,522	36,619	46,657	57,319
Adjustments to reconcile net income to net cash by op activity						
Depreciation and amortization	3,590	4,801	6,629	8,868	12,001	16,105
Share-based compensation	1,785	2,497	2,925	4,179	5,247	5,418
Net interest expense/(income)	(1,455)	(494)	(577)	(296)	(39)	(1,963)
Deferred income tax	4,107	5,125	7,013	9,155	11,664	19,106
Changes in working capital:						
-(Increase)/decrease in accounts receivable (net of allowances)	(601)	(1,633)	(2,473)	(2,012)	(2,114)	(2,167)
-(Increase)/decrease in restricted cash	(1,611)	(5,043)	(45,557)	(10,946)	(13,135)	(15,763)
-(Increase)/decrease in inventories	(816)	1,140	22	222	0	0
-(Increase)/decrease in prepayments and other current assets	(7,304)	6,386	(30,126)	(12,859)	(11,760)	(15,639)
-Increase/(decrease) in accounts payable	2,468	2,003	7,017	4,394	6,010	3,752
-Increase/(decrease) in advance from related parties	129	1,501	726	0	0	0
-Increase/(decrease) in deferred revenues	3,726	4,312	4,969	(89)	8,909	(512)
-Increase/(decrease) in other payables & acc'l's	3,945	8,877	51,076	(9,275)	47,389	(11,626)
Cash generated from operations	23,525	53,360	31,166	27,959	110,830	54,029
Interest paid	1,455	494	577	296	39	1,963
Taxation paid	(4,107)	(5,125)	(7,013)	(9,155)	(11,664)	(19,106)
Net cash (used in) from operating activities	20,873	48,729	24,730	19,100	99,204	36,886
Changes in working capital:	(64)	17,543	(15,544)	(29,367)	35,299	(41,955)
CASH FLOW FROM INVESTING ACTIVITIES:						
Payments for business combinations, net of cash acquired	4	(1,911)	(1,109)	(3,562)	(4,473)	(5,418)
Purchase of fixed assets & CIP	(4,788)	(4,718)	(7,709)	(9,973)	(14,312)	(19,504)
Payment for leasehold land and land use rights	(77)	120	(1,542)	0	0	0
Purchase of intangible assets	(560)	(7,242)	(5,143)	(7,123)	(8,945)	(10,835)
Purchase of available-for-sale financial assets	(6,882)	(762)	(31,062)	(4,434)	(4,877)	(5,365)
Increase /(decrease) in term deposits (>3mths)	(528)	6,589	1,157	(735)	(882)	(1,058)
Interest income received	1,539	1,676	2,327	2,431	2,442	4,671
Net cash in investing activities	(11,292)	(6,248)	(43,081)	(23,395)	(31,047)	(37,508)
CASH FLOW FROM FINANCING ACTIVITIES:						
Repayment of loans	4,444	22,627	28,793	(3,149)	(2,550)	(3,150)
Proceeds from issue of ordinary shares	140	154	169	186	205	225
Payments for repurchase of shares	(1,485)	(1,485)	(1,485)	(1,485)	(1,485)	(1,485)
Dividends paid	(1,108)	(2,126)	(2,627)	(3,259)	(4,152)	(5,101)
Net cash provided by financing activities	1,991	19,170	24,850	(7,706)	(7,983)	(9,511)
Effect of exchange rate changes on cash and cash equivalents	(2)	(2)	(3)	(3)	(3)	(4)
Net increase in cash and cash equivalents	11,572	61,651	5,301	(10,803)	60,175	(10,132)
Cash and cash equivalents at beginning of the year	17,004	20,228	42,713	43,438	32,632	92,803
Cash and cash equivalents at end of the year	20,228	42,713	43,438	32,632	92,803	82,668

Source: Tencent, BLRI (as of 4/1/2016)

See the last page of the report for important disclosures

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