

Equity Research
Internet
Robust 2Q Earnings; Positive Outlook

Thanks to the strong performance in online games and online ad., Tencent 2Q revenues were up 37% yoy and 7% qoq to RMB19.7bn, 3% above our estimates. Better revenue mix driving GPM up to 61.6% in 2Q from 57.6% in 1Q. Net profit grew 59% yoy to RMB5.8bn, beating consensus by 9%. We lift our SOTP-based target price to \$160 which implies 34.8x FY15E/28.2x FY16E P/E. Maintain BUY.

Mobile games beat expectation. Tencent online games revenue growth accelerated to 46% yoy in 2Q14 (vs 39% yoy in 1Q) driven by strong mobile games growth (2Q ARPU is RMB100-110 vs RMB80-90 in 1Q) and contribution from PC games titles such as Assault Fire, Blade & Soul and LOL. Mobile games contributed RMB 3bn revenues, up 67% qoq. Management expects mobile game revenue to stay flat for the next few quarters as it is shifting focus from self-developed games to 3rd party games. The company will put more effort in user engagement and platform enhancement to sustain long-term growth.

Impressive performance in online advertising. Advertising revenue surged 59% yoy and 75% qoq to RMB 2.1bn, mainly driven by the increase in video ad and performance-based ad. World Cup and strategic cooperation with JD.com were two key positives in 2Q. Mobile news DAU reached 180mn (double that of PC). Going forward, the company will improve targeting technology to attract larger advertiser base. We believe ad revenue from Mobile Qzone and text ad links on Weixin official accounts are key future drivers of ad business.

Internet finance business a long term growth driver. Tencent recently obtained approval for its internet banking license. Management does not expect the company to compete directly with the traditional banks. They will target credit markets which are currently underserved such as SME loans and micro-financing. Tencent could leverage its big data and cooperate with traditional banks to identify attractive borrowers and design innovative products.

Maintain BUY with TP of HK\$160. We continue to use SOTP method to value Tencent and lift our target price to \$160 from \$140 due to 1) the re-rating of its online ad business 2) better revenue mix and margins expansion (reducing contribution from eCommerce due to traffic shift to JD.com) 3) huge potential in internet finance business (by exploring long-tail opportunities in credit markets). Our new TP implies 34.8x FY15E/28.2x FY16E P/E.

Financials

RMB mn	2013A	2014E	2015E	2016E
Revenue	60,437	80,782	96,095	118,508
Revenue growth	37.69%	33.66%	18.96%	23.32%
Gross profit	32,659	49,320	61,243	75,854
Gross profit margin	54.04%	61.05%	63.73%	64.01%
Net profit	15,502	26,312	34,322	42,336
Net profit margin	26%	33%	36%	36%
EPS	1.69	2.82	3.68	4.54

Source: Company data, CSCI
**Tencent Holdings
(700.hk)**

Rating	Buy
Target Price	HK\$160
Price	HK\$ 130.1
Upside	23%

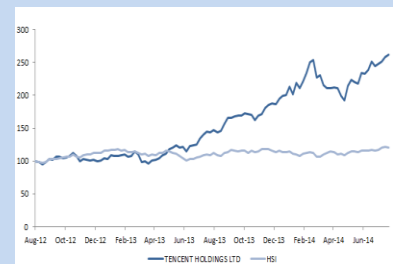
Market data	08/14/2014
52-wk range(HK\$):	70.2/134
Market cap.(HK\$ bn):	1,218
Shares out. (mn):	9,343
Major shareholders:	
MIH TC	33.73%
Advance Data Service	10.16%
Avg. Daily Vol. (mn):	43

Valuation	13A	14E	15E	16E
EPS (RMB)	1.7	2.8	3.7	4.5
PE (x)	61.6	37.0	28.3	23
PB (x)	16.3	11.6	8.4	6.3
Yield (%)	0.2	0.3	0.4	0.5

Stock rel HSI performance (%)

Since 14 Aug 2013

+80%/+10.4%


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14 Aug 2014

Financial Summary											
Income Statement (RMB m)						Financial Ratios					
	2012A	2013A	2014F	2015F	2016F		2012A	2013A	2014F	2015F	2016F
VAS	35,718	44,985	65,069	82,122	103,861	Revenue growth (%)	54.0%	38%	34%	19%	23%
Online advertising	3,382	5,034	8,363	10,966	11,803	Operating profit growth (%)	27.5%	26%	72%	29%	23%
eCommerce transactions	4,428	9,796	5,692	1,138	228	Net profit growth (%)	24.8%	22%	70%	30%	23%
Others	365	622	1,657	1,869	2,617	Adjusted profit growth (%)	24.8%	22%	70%	30%	23%
Revenue	43,894	60,437	80,782	96,095	118,508	Adjusted EPS growth (%)	24.2%	21%	67%	30%	23%
Cost of sales	(18,207)	(27,778)	(31,462)	(34,852)	(42,653)	Dividend growth (%)	33.3%	19%	59%	32%	26%
Gross profit	25,686	32,659	49,320	61,243	75,854	Dividend payout (%)	9.2%	9%	9%	9%	9%
R&D expenses	-	-	-	-	-	Gross profit margin (%)	58.5%	54%	61%	64%	64%
SG&A expenses	(2,993)	(5,695)	(7,755)	(9,033)	(11,021)	Operating profit margin (%)	41.2%	38%	49%	53%	53%
Other operating expenses	552	2,218	323	480	119	Adjusted profit margin (%)	29.0%	26%	33%	36%	36%
Operating profit	15,479	19,194	31,820	41,538	51,303	ROE (%)	30.2%	27%	31%	30%	27%
Finance costs	348	84	80	89	90	ROA (%)	16.9%	14%	19%	20%	19%
Other income	(54)	213	220	230	250	Net debt/shareholders' equity (x)	-6.4%	-9%	-23%	-43%	-57%
Profit before taxation	15,051	19,281	31,900	41,599	51,364	Net debt/total assets (%)	-3.6%	-5%	-14%	-29%	-40%
Taxation	(2,266)	(3,718)	(5,515)	(7,197)	(8,937)	Current ratio (%)	176.7%	161%	202%	274%	322%
Non-controlling interests	53	61	72	80	90	Interest cover (x)	3663.8%	18454.8%	32890.5%	38564.5%	47040.3%
Net profit	12,732	15,502	26,312	34,322	42,336						
Balance Sheet (RMB m)						Cash Flows (RMB m)					
	2012A	2013A	2014F	2015F	2016F		2012A	2013A	2014F	2015F	2016F
Fixed assets	7,937	10,734	34,115	35,459	37,548	Operating profit	15,479	19,194	31,820	41,538	51,303
Associates & JCE	12,816	24,510	26,580	27,423	29,416	Depreciation & amortization	2,620	3,606	7,469	9,227	10,947
Others	13,275	14,202	592	599	621	Others	(2,502)	(1,951)	(14,845)	(9,411)	(19,083)
Non-current assets	25,930	29,039	38,810	40,161	42,272	Change in working capital	6,098	(193)	1,911	375	2,456
Inventories	568	1,384	524	581	711	Tax paid	(2,266)	3,718	5,515	7,197	8,937
Debtors & prepayments	6,232	8,320	9,649	11,478	14,155	Operating activities	19,430	24,374	31,870	48,925	54,559
Bank deposits & cash	13,383	20,228	36,624	67,233	104,878	CAPEX	(4,839)	(6,081)	(8,078)	(10,570)	(13,036)
Others	16,326	23,754	23,894	24,521	26,789	Purchase of assets	(33,772)	(30,469)	(5,000)	(4,800)	(1,200)
Current assets	36,509	53,686	70,691	103,813	146,533	Disposal of non-current assets	17,581	15,035	-	-	-
Bank & other borrowings	1,077	2,589	2,680	2,680	2,680	Proceeds from investments	-	-	-	-	-
Trade & payables	4,212	6,680	6,118	6,293	7,583	Others	3,694	1,294	(1,135)	(952)	(80)
Taxation	960	1,911	980	995	1,100	Investing activities	(16,270)	(19,134)	(13,089)	(15,168)	(13,141)
Current liabilities	20,665	33,267	34,947	37,849	45,485	New loans raised	6,966	7,013	7,800	7,900	8,000
Bank & other borrowings	9,622	12,464	14,456	14,826	14,432	Repayment of loans	(8,066)	(2,314)	(8,900)	(8,900)	(8,900)
Others	2,820	3,041	3,142	3,111	3,216	Dividends paid	(1,108)	(1,468)	(1,401)	(2,263)	(2,986)
Non-current liabilities	12,443	15,505	17,598	17,937	17,648	Others	(275)	(228)	(2)	(2)	(2)
Net assets	42,148	58,463	83,537	115,610	155,087	Financing activities	(2,386)	1,708	(2,383)	(3,145)	(3,768)
Share capital	0	-	0	0	0	Incl(dec) in cash	773	6,948	16,397	30,612	37,650
Premium & reserves	41,297	57,945	82,856	114,916	154,266	Cash at beginning of year	12,612	13,383	20,228	36,624	67,233
Shareholders' funds	41,298	57,945	82,857	114,916	154,266	Foreign exchange effect	(2)	(103)	(2)	(3)	(5)
Non-controlling interests	851	518	680	694	821	Cash at end of year	13,383	20,228	36,624	67,233	104,878
Total equity	42,148	58,463	83,537	115,610	155,087						

Source: CSCI

Company Rating Definition

The Benchmark: Hong Kong Hang Seng Index; Time Horizon: 12 months

Buy	Relative Performance >15%;
Accumulate	Relative Performance is 5% to 15%;
Neutral	Relative Performance is -5% to 5%;
Reduce	Relative Performance is -5% to -15%;
Sell	Relative Performance is <-15%;

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