

September 21, 2015

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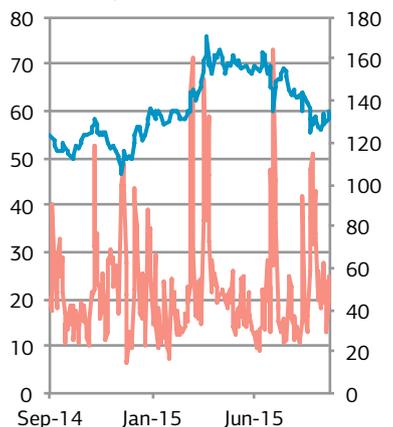
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Tencent (0700 HK)

Price	HKD 135.10
Rating	SELL
Price Target	HKD 99.50
P/E	29x

Tencent (0700 HK) last share price in HKD (blue) and volume (pink, in mln shares)



Tencent Holdings Ltd (0700 HK)

Hitting the Top with WeChat

- ▶ **In Q2, Tencent saw its** first QoQ decline in gaming revenue since 2010. We expect this to continue. The ongoing secular shift to mobile games is emphasizing casual games, which have a lower ARPU than PC games, and this inevitably will lead to lower gaming revenue. Meanwhile, Apple's new policy of allowing gamers to sign into any system with their Apple ID has undermined Tencent's ability to lure users to its own gaming platform from the iStore. For Android app stores, Tencent has always been the also-ran.
- ▶ **Tencent has done well** with WeChat advertising, but we see this as having hit a ceiling. Even with the most optimistic assumptions, ad revenue on WeChat will not make up for a decline in gaming revenue.
- ▶ **The company is paying** a 10% effective interest rate on debt, and yet the notes it has reported average just over 4%. Are there more borrowings than we know about?
- ▶ **We reiterate our sell rating** on Tencent with a target price of HKD 99.5 based on an estimated 2015 EPS of HKD 3.47 with a 2016 P/E of 29X.

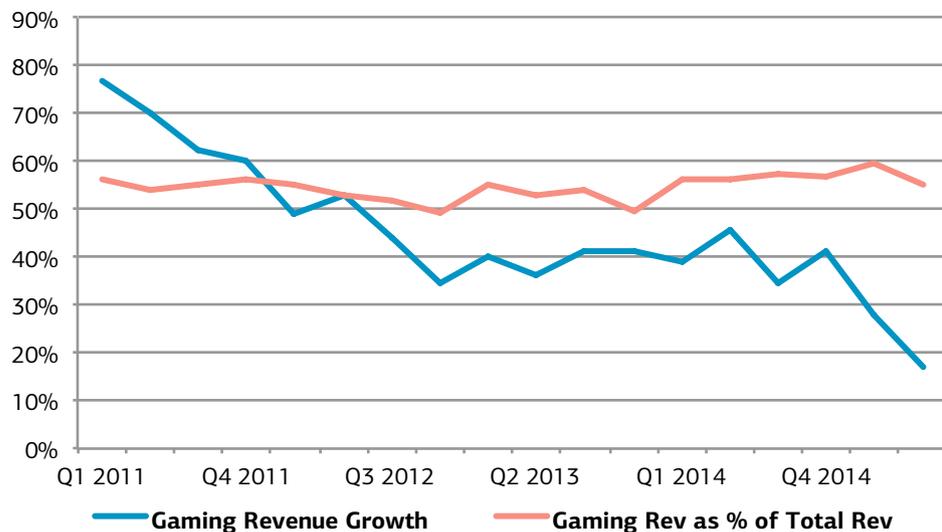
Tencent's gaming revenue showed negative growth in Q2 2015.

Shifting Revenue Streams

Gaming has always been the major contributor to Tencent's revenue, and gaming overall has remained steady at 55%, while mobile gaming has grown rapidly as a proportion and is now 35% of gaming revenue. Since 2011, the company's gaming growth has fallen from 77% to 17%.

Tencent's gaming revenue showed negative growth QoQ in Q2 2015 for the first time since 2010.

Chart 1. Gaming Growth YoY



Source: Company data

Shifting to Mobile

It is uncontroversial that gaming is moving from the PC to the mobile phone, and Tencent is no exception: revenue from mobile games contributes more and more to total gaming revenue, going from 7% in Q4 2013 Q4 to 35% in Q2 2015. Yet this may not be good news for Tencent.

- ▶ First, Tencent has no traffic advantage anymore. Tencent was very successful in converting QQ users to players on its gaming platform, but in mid 2014, Apple enabled gamers on all gaming platforms to log with an Apple ID. So now, gamers need not establish a WeChat or QQ account to log into Tencent games—they can stay on the Apple platform and play everyone's games.
- ▶ Tencent's own app store is much less popular than Apple's for

iPhones and is less popular for Android games than Baidu's. Tencent lacks channels to promote its own games and relies heavily on these other app stores. The iStore is more valuable as a testing and promotion platform, especially when more and more of Tencent's games are from third parties rather than from Tencent itself.

Chart 2. Mobile Game Revenue as a % of All Gaming Revenue

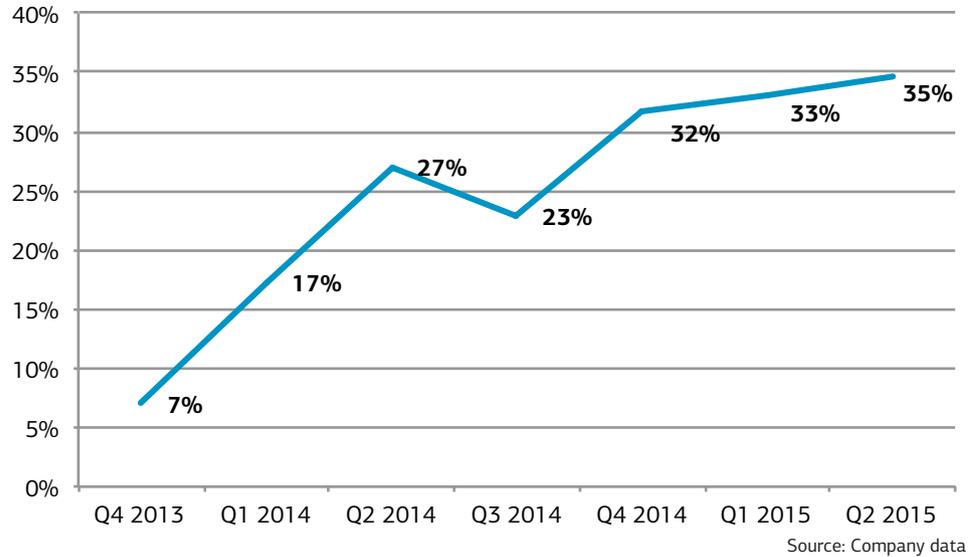
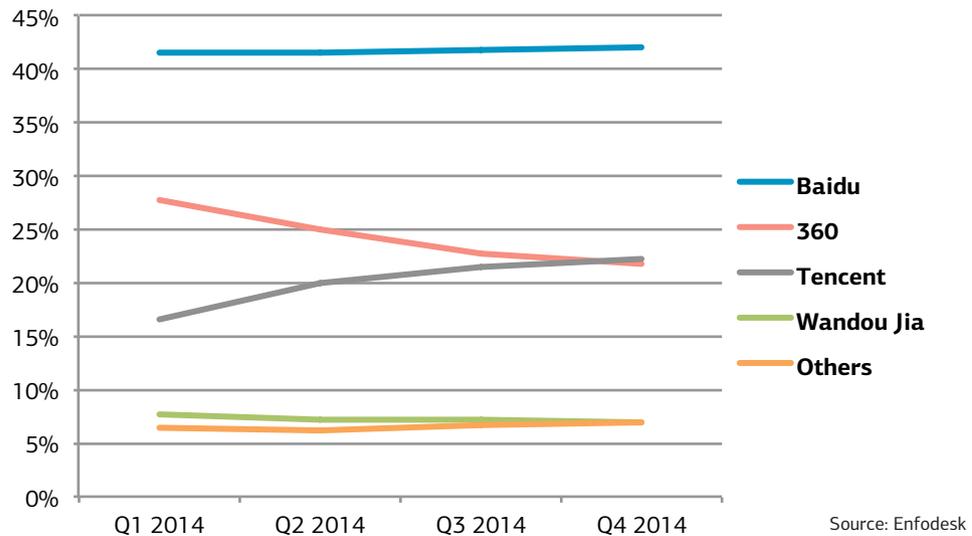


Chart 3. Android App Store Market Share



- ▶ Monetization is likely to fall. Tencent is best at casual and social games based on Wechat and QQ mobile. Yet casual games are often free, while social games often have an ARPU ceiling. Immersive

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MMORPGs are the real gold mine. Tencent says that 46% of its players do not pay, and the company has only one immersive game, [ranked 19th](#) on the iStore as of June 4. Already, Q1 2015 [saw flat ARPU](#) for games on Mobile QQ and Wechat.

Table 1. Tencent's Mobile Game ARPU

Mobile QQ and Weixin Games	Q4 2013	Q1 2014	Q2 2014	Q3 2014	Q4 2014	Q1 2015	Q2 2015
ARPU range (RMB)	60-70	80-90	100-110	100-110	155-165	155-165	165-175

Source: Company data

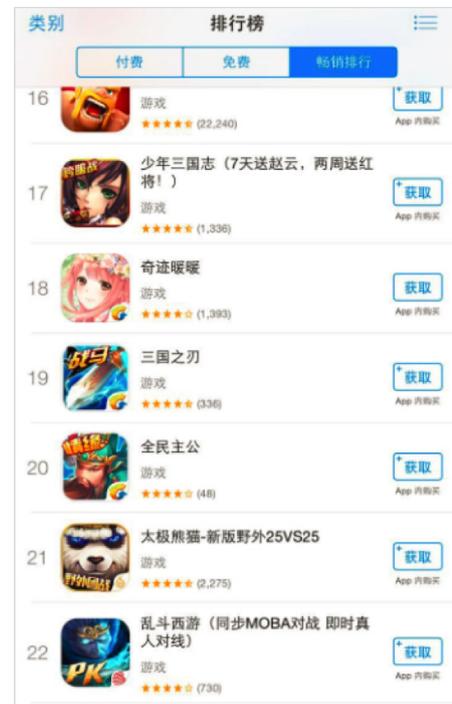
- ▶ The company's strategy for gaming going forward [focuses on](#) card games. But card games are slipping in popularity, according to mGameTracker data on market share of top 50 games. Card game penetration [decreased](#) from 33% to 22% between Q1 2014 and Q1 2015. We are concerned about the growth potential of Tencent's gaming business.

Is Advertising the New Growth Engine?

WeChat ad growth has a natural limit given the relatively light interactivity for WeChat. In Q1 2015, advertising revenue was RMB 6.1 bln, up 77% YoY. Of the total, 67% was placed in the Internet and the balance on WeChat. At the end of Q2 2015, WeChat had an active user count of 600 mln, up 37% YoY, and monthly active users amounted to 470 mln.

WeChat is reaching its ceiling. This is partly because there is a limit to the number of news feeds that Wechat can accommodate.

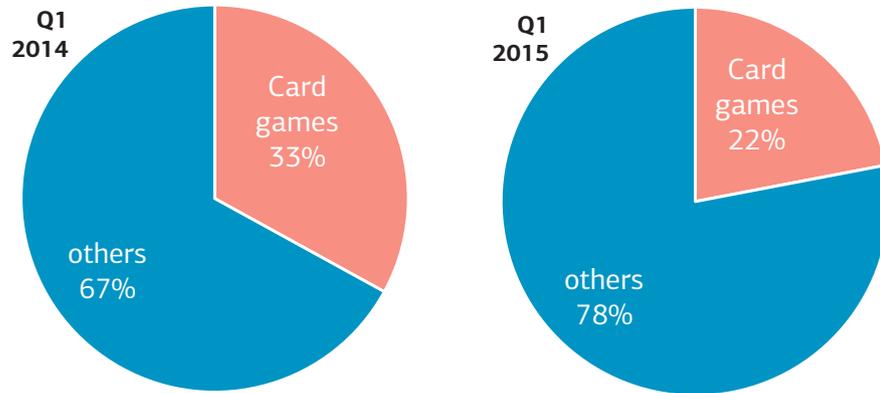
Based on the most positive calculation for potential WeChat ad revenue, we



Screenshot: Tencent's Popular Immersive Game based on the Romance of the Three Kingdoms ranks No. 19.

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Chart 4. Card Games as a % of the Total



Source: mGameTracker

can assume that there are 100 mln user views each day for the four daily news feeds. Assume each one checks his or her phone at least four times a day and each time checks the “Moments” updates from friends and sees a news feed advertisement.

Given industry CPM standards ranging from 10-100 CPM, and assuming Tencent gets the top amount, those daily views would generate RMB 14.6 bln. That would make up for at most a 10% decline in gaming revenue. Yet the assumptions are generous. Checking the feed on an iPhone 6 Plus with a 5.5-inch screen would not be a great experience and so would decrease the views.

More importantly, ad growth is not sustainable.

Take Facebook: in Q2 2015, ad revenue [contributed](#) USD 3.8 bln, or 94% of the total revenue of Facebook. WeChat cannot achieve numbers like that: WeChat circles consist of close, intimate circles with strong relationships, while Facebook is much more open and similar to Weibo. That means Facebook ads have wider exposure.

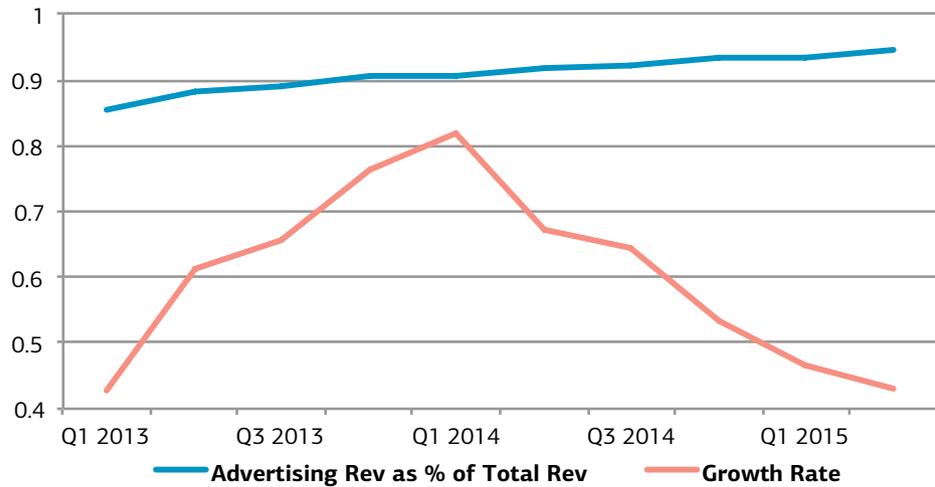
Even Facebook is now facing the problem of limited space for advertising. Its ad growth rate in Q2 2015 was the slowest quarter since 2013. After selling the sidebars and news feeds, Facebook starts selling the log-out page. Pricing may grow but that could push clients to other platforms.

Cash Does Not Add Up

Tencent’s effective reported interest costs have gone from 1% in 2009 to 10% today. **And yet the highest rate on a note issued since 2009 is 4.625%.** Even though long-term borrowings have risen to 63% of total li-

Even Facebook is now facing the problem of limited space for advertising.

Chart 5. Facebook Advertising Revenue Slowing



Source: Company data

abilities, the rate on those borrowings would have to be around 15% to pull up the average to 10%.

Table 2. Issuance of Notes Financing

Date	Amount	Rate
12/6/2011	USD 600 mln	4.63%
8/29/2012	USD 600 mln	3.75%
4/30/2014	USD 500 mln	2.00%
4/30/2014	USD 2,000 mln	3.38%
2/12/2015	USD 1,100 mln	2.88%
2/12/2015	USD 900 mln	3.80%

Source: Company data

Cash Is All from Financing

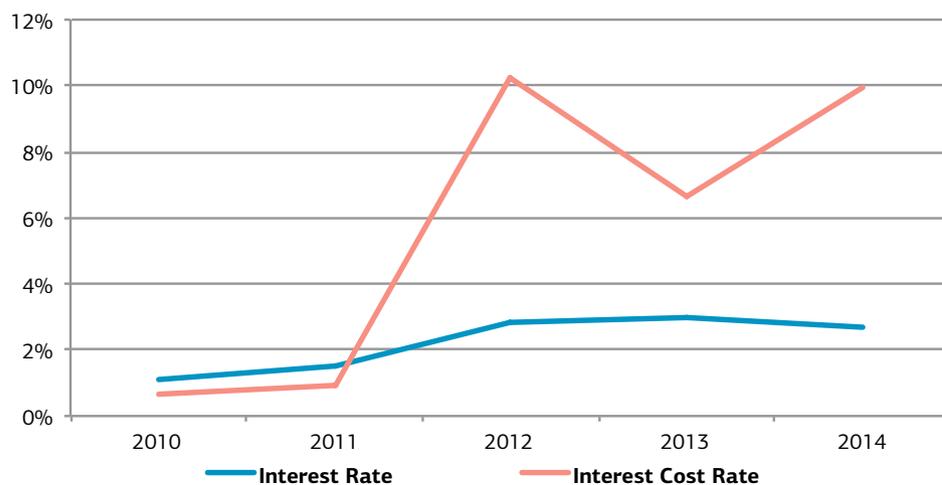
At the end of 2014, the company had an impressive stockpile of RMB 43 bln in cash. Yet we find that Tencent is weak in generating cash without financing activities, as indicated by the red line below. Without the financing, additional cash inflows fluctuate a lot, while the cash balance is in tune with the financing activities.

Inefficient Investments in Associates

As of end of 2014, Tencent’s investment in associates was RMB 51 bln, yet those investments have never generated profit. In 2014, for example, investments in associates increased 370% YoY and yet these companies have not made any profit for the past four years.

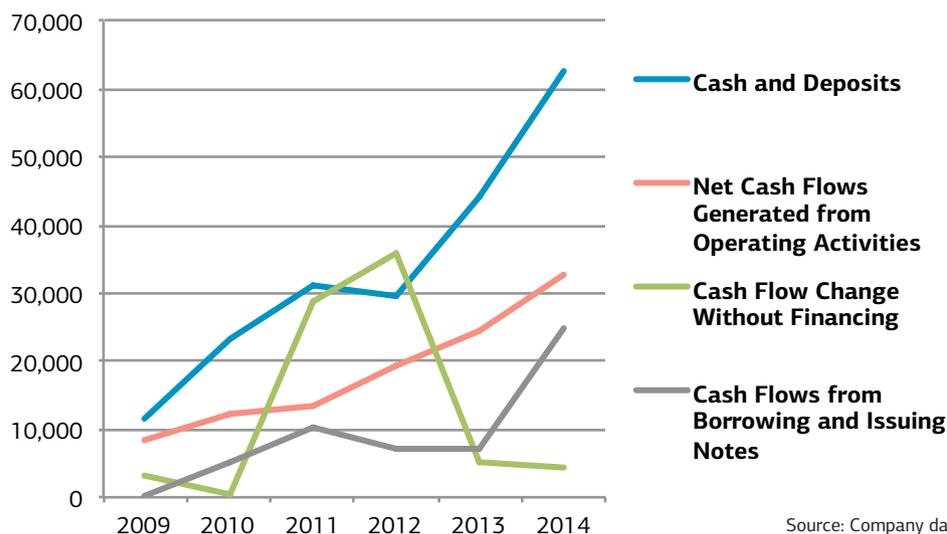
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Chart 6. Interest Cost and Interest Income



Source: Company data

Chart 7. Tencent Cash Flow



Source: Company data

Table 3. Investment in Associates

RMB mln	Q1 2015	Q4 2014	% Change
Investments in Associates	53,161	51,131	4%
Investments in Redeemable Preference Shares of Associates	4,276	2,941	45%
Investment in Joint Ventures	563	63	794%
Available-for-Sale Financial Assets	17,171	13,277	29%
Total	75,171	67,412	12%

Source: Company data

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Table 4. Investment in Associates and Losses

RMB mln	2011	2012	2013	2014
Investment in Associates	4,433	7,310	10,867	51,131
Loss of Investment in Associates	190	81	171	347

Source: Company data

Valuation

We reiterate our SELL rating on Tencent with a TP of HKD 99.5 based on an estimated 2015 EPS of HKD 3.47. The PT implies a 2016 P/E of 29X.

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