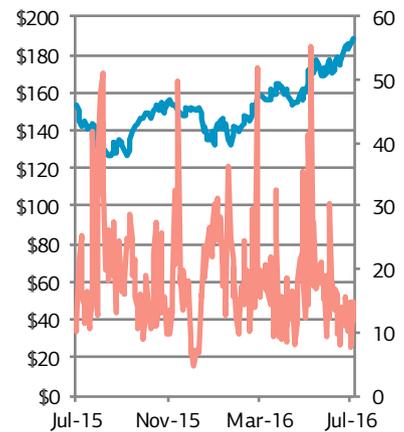


August 1, 2016
Closing Coverage

Tencent (0700 HKG)

Price	HKD 186.70
Rating	SELL
Price Target	HKD 99.50
Market Cap	HKD 1.74 T
Free Float	56%
P/E	51.26X

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



Source: Bloomberg

Tencent Holdings Ltd. (0700 HKG) Supercheat

▶ Supercell Suspicions

We think Tencent is using the Supercell deal as a channel to move money out of China. The company is raising money through a low-interest project loan in China and equity partners offshore; it is not putting up virtually any of its USD 13.8 bln in cash.

▶ Few Deal Benefits

The deal is focused on capital gain once Supercell achieves an IPO. Tencent may realize no income from the deal at all, as the company will account for dividends paid by Supercell but will not consolidate its holdings or recognize equity earnings from Supercell.

▶ Closing Coverage

We continue to believe that Tencent has significantly less revenue and lower cash balances than the company reports. However, we see no near-term catalyst for the market to reassess the value of this stock. Therefore, we are closing coverage of Tencent.

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The deal values Supercell at USD 10.2 bln.

A Suspicious Deal

■ Nan Yiyi

Tencent has made front-page news with the largest overseas acquisition deal yet to be undertaken by a Chinese company, acquiring 84.3% of Supercell Oy, a Finnish mobile gaming company with four hugely popular games and over 100 mln active players all over the world. Tencent has committed to pay USD 8.6 bln at a valuation of USD 10.2 bln for Supercell, almost double that of a year ago.

Supercell's gaming metrics stack up favorably compared with Tencent's. With 100 mln active users, a 12% conversion rate, and about USD 48 in payment per paying user, Supercell gets about USD 576 mln per quarter in gaming revenues, making each active gamer worth USD 23.04 per year. Although Tencent does not provide the metrics, we calculate that Tencent converts around 10% of its 491.7 mln gamers, assuming that 55% of user of WeChat and Mobile QQ are gamers and that there is an 80% overlap between users of the two apps. The average annual payment of USD 96 makes each gamer (paid or unpaid) worth USD 3.55 each annually. Total gamers in China number 534 mln, according to 2015 China Gaming Industry, and average conversion rate is less than 3%, meaning that Tencent, despite having such a commanding share, outperforms the segment.

Table 1. Tencent and Supercell Gaming Metrics

	Tencent	Supercell
Mobile Game Active Player Base	419.7 mln quarterly as of Q1 2016	100 mln daily as of March 2016
ARPU Range	155-165 RMB as of Q1 2016	Around 48 USD as of March 2016
% of Paying Games	10% as of Q1 2016	12%

Source: [Quora](#)

Tencent's mobile gaming revenue for 2015 was US 3.2 bln, making Supercell's gaming business, at USD 2.3 bln, 72% the size of Tencent's. For Tencent, gaming revenue is 55% of the total. Tencent's market valuation is about USD 223 bln, meaning that the gaming business is valued at about USD 122.6 bln. On a like-on-like basis, then, 72% of Tencent's gaming business is valued at about USD 88 bln, or about nine times the valuation that Supercell has attracted.

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Ostensibly, Supercell offers to Tencent a powerful revenue engine for the WeChat mobile platform. WeChat and the QQ platform will expand Supercell's player base in China and expand Tencent's ability to monetize the platform. There is some precedent: Tencent acquired Riot, League of Legend in 2015. But the company has offered no detail in its public reports.

Despite optical synergies, we believe that the real motivation for the deal has more to do with its financing structure: Tencent may be channeling capital overseas.

Tencent's Motivation: Capital Gain

According to Tencent's announcement, it expects to maintain a 50% voting interest in the buyer consortium and to book distribution of profit or dividend, if any, rather than accounting for equity or consolidated revenue. Before Supercell transfers its shares to Tencent, it will pay Softbank and its other shareholders dividends of USD 1.1 bln, according to Business Wire, exceeding all profit in 2015.

Historically, the payout ratio of Supercell has been high, 56% of profit in 2014 and 72% in 2015, not including the additional dividend payout before the share transfer.

Using this method of accounting, Tencent will have no obligation to disclose the details of the Supercell's financials or its transactions with Tencent, even as Supercell becomes Tencent's largest related party. Such an important new Tencent subsidiary will be disclosed only insofar as Tencent receives a share of dividends.

Table 2. Supercell Profit and Dividends 2014-15

USD	2014	2015
Profit	592 mln	924 mln
Dividends	330.74 mln	669 mln
Payout ratio	56%	72%

Source: Venturebeat, Wall Street Journal

The Financing Package

Sitting on a reported USD 13.8 bln in cash, Tencent nevertheless plans to finance the whole deal. Some USD 4 bln is to come from co-investors; disclosed potential partners include the Canada Pension Plan Investment Board, China Investment Corp., and Hillhouse Capital Group, according to Hong Kong press sources.

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As to the rest of the purchase price, in May, Tencent obtained USD 4.4 bln in syndicated loans from over 20 banks with an interest rate 102 bps above LIBOR.

Even with this financing, Tencent [is trying](#) to raise another USD 3.5 bln in non-recourse loans for this deal at less than 2%. Non-recourse financing entitles the lender to repayment only from the profits of the project the loan is funding rather than from the other assets of the borrower. This means that Tencent does not share in risk from this deal. The terms apparently require that profit from Supercell be preferentially directed to the lenders' accounts. The lending consortium establishes a special-purpose vehicle to act as the creditor. In the first four years, net profit from Supercell will likely be used to repay the loan. This is also may be the reason that Tencent does not want to consolidate Supercell into its financials, as no gain is expected from Supercell unless capital gains when Supercell is sold again.

Tencent believes that a Supercell IPO by 2020 will achieve a 36% annual return starting from 2016, according to Wall Street Journal coverage.

So why would Tencent buy Supercell if it looks like that Tencent doesn't benefit from a share of gains for the next a few years? We believe that Tencent is simply taking cheap Renminbi loans and converting them to hard currency.

Although we have found no evidence that Tencent's investment companies are selling the deal to Chinese investors, this activity is extremely common in China, and we would be surprised if the Supercell deal did not turn up for sale to the retail public on a wealth management platform in China. After all, a 36% annual return is nearly guaranteed!

The terms of non-recourse financing are extremely attractive for Tencent. In general, non-recourse loans are provided to central-level SOEs and carry very low interest rates of 1-2% annually. ChinaChem, now bidding to purchase Syngenta, has received several such loans. In its acquisition a decade ago of Adisseo, a French nutritional supplements firm, ChinaChem received a non-recourse loan from the China Development Bank. In March 2015, ChinaChem acquired Pirelli & C. SpA with USD 7.4 bln in non-recourse financing from a group of 18 banks.

Tencent, a private company, appears to have slipped into the favored class of recipients of such loans after the inclusion of China Investment Corp., China's sovereign fund, in the consortium.

Tencent may be converting cheap RMB loans into hard currency.

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Overall, it will cost Tencent little to finance the deal given backing by China's sovereign fund. We expect Tencent-associated financing companies to issue trust products and wealth-management products. Recently deals such as Anbang Insurance's bid for the Starwood Group have been torpedoed by regulators. A deal that has already secured the backing of a central-government fund like CIC is more or less certain to go through. This is also why the B round financing for Alipay, the third-party payment company associated with Alibaba, was limited to SOEs.

SuperValuation

The deal was a bit pricey. To provide a comparison, King Digital Entertainment PLC was purchased by Activision Blizzard Inc. for USD 5.9 bln last year largely on the popularity of its "Candy Crush" games. During the 12 months ended September 30, 2015, King's revenue was USD 2.1 bln and its USD 570 mln in profit implies a PE of 9.83x. King has over 500 mln active players worldwide, according to the acquisition announcement. Based on Supercell's USD 924 mln net profit and USD 2.3 bln in revenue last year, this transaction values Supercell at 11x 2015 earnings. China International Capital Corporation Limited (CICC) estimates that Supercell can grow its earnings by 30% this year (it grew 63% in 2015), which would value Supercell at 10x 2016 earnings. This is risky. Mobile games are seeing shorter lifecycles and lower retention rates than PC-based games. Before Tencent closed the deal, it had to raise its offer to beat back bids by Shanda and Alibaba.

Table 3. Gaming Company Comparison

USD	MKT cap	PE	Gaming Rev
Supercell	10.20bln	10.93	2.33bln
Netease	3.35bln	21.99	2.67bln
Electronic Arts Inc.	22.78bln	21.37	4.40bln
Zynga	2.41bln	NA	0.59bln
Tencent	225.66bln	49.56	3.19bln

Source: Google Finance

Valuation

Our target price of HKD 99.50 is based on our DCF valuation. We believe the true reason for Tencent's world shopping expedition is a strategy to transfer capital overseas and to inflate the balance sheet with intangible assets. We believe that Tencent does not have the cash it claims, but it does have access to deep Chinese government resources. We are closing coverage because there is no near-term catalyst for the stock.

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