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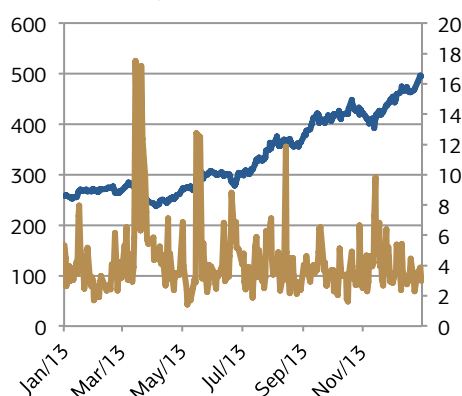
China | TMT

Tencent (0700 HK)

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Tencent (0700 HK) one-year share price in HKD (blue) and volume (gold, in mln shares)



Source: Bloomberg

Tencent (0700 HK)

Price	HKD 502
Rating	Sell
Price Target	HKD 213
Difference	58%
Market Cap	HKD 925.48 B
Simple Moving Avg.	3.87 M
P/E	47.68X
Free Float	56%

Source: Bloomberg



Loan Shark?

+ Online Finance

Tencent has spent RMB 1.6 bln of 10 bln planned to date on establishing new companies in online, "peer-to-peer" lending in the special zone of Qianhai in Shenzhen, China's capital for processing in- and outbound hot-money flows.

+ Questionable Investments

We find Tencent's recent investment in HowBuy, an online lender, and its cooperation with Guojin Securities to be of questionable value to Tencent's business as reported.

+ High-Interest Lending

Tencent has been accused in the Chinese press of engaging in loan sharking and in employing a third-party collections agency that used physical violence to collect debts. The news was promptly deleted from the internet.

+ Reiterate SELL rating, unchanged PT of HK213

We arrive our price target based on a DCF valuation model with a WACC of 13.4% and long-term growth rate of 3%. We reiterate our sell rating with the price target unchanged.

Tencent's New Finance Business

In Q4 of 2013, Tencent disclosed several investments that appear to support a growing business in high-interest lending. We believe that these businesses contain a higher level of risk than is acknowledged in the perfunctory disclosures, and they also call into question the real growth potential of Tencent's core gaming and advertising offerings, given that Tencent is putting much of its investment capital and its bureaucratic energy into these finance businesses.

Qianhai is China's capital of hot-money processing.

Qianhai

On October 10, Tencent reported that it had invested RMB 1.6 bln in Qianhai, Shenzhen, to establish six companies in online financial information services and would invest more than RMB 10 bln in this area altogether.¹ The six companies are engaged in e-commerce, small loans, and private equity.

The district of Qianhai in Shenzhen is China's capital of underground banking, due to proximity to Hong Kong and policy benefits provided by the city government. Trading companies in the district process flows of hard currency in and out of China, often using fraudulent invoices, according to the Chinese press and to regulatory agencies.² Our own interviews suggest that large-scale transfers of hard currency in or out of China, highly restricted when conducted formally, are facilitated in this area for fees of up to 3%. In the past, we have questioned Tencent's USD borrowings despite rich cash balances equivalent to more than USD 7 bln, and we think it is possible that Tencent may participate in some of the lucrative businesses associated with processing hard currency investments in China's wealth market.

To cope with regulatory restrictions on finance activities by non-banking institutions, companies need three distinct types of subsidiaries: a guarantor, a loan company, and an investment company. The loan company can recruit capital and extend loans on a consulting basis but not manage funds. The investment company can manage capital, and the guarantor backs loans. Tencent now has investment and loan companies.

We believe that Tencent is already engaged in high-interest

¹ <http://finance.sina.com.cn/money/smjj/20131212/070017609339.shtml>

² <http://finance.sina.com.cn/china/dfjj/20120709/111212513715.shtml>

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lending, as has been reported in the Chinese press. Chinese accounts reported recently that one Tencent office had employed a collections agency to assault someone who had failed to repay a small loan. The news, which appeared in multiple press outlets, was soon deleted from the internet. Our checks on Tencent's Tenpay business in 2013 indicated that Tencent lends customer deposits. Tencent has signed cooperation agreements with at least three banks, which refer potential borrowers, and extends loans of usually 15 days in duration.

Guojin

On November 22, Tencent partnered with Guojin Securities in an online financial services platform and said it would likely invest in Guojin in the future.³ According to the agreement, Guojin will pay the extraordinarily low price of RMB 18 mln to Tencent in advertising for two years in order to sell its investment products. Should the incoming capital transit Tencent's payment platform, Tenpay, then Tencent will receive a commission, but only for high volumes of cash.

Guojin Securities, which ranked third-to-last among 19 listed securities companies in net profit for the first three quarters of 2013, has seen its profit grow by only 2.53% YoY. Until December 24, short interest in Guojin was the highest of all the listed brokers, with 36 mln shares borrowed since May. But on Christmas Eve, all the short interest was covered.⁴ The securities firm has a checkered past, with the former CEO of its controlling shareholder, Yongjin Group, committing suicide following a 2008 scandal.

How Now?

On December 16, Chinese financial product provider HowBuy said that it had secured an undisclosed amount of investment capital from Tencent as well as from Legend Capital. Baidu has also invested in the HowBuy Group.⁵ HowBuy recruits capital via a call center, online channels, and storefronts and places the capital into trusts and other investments. The investments are generally fixed-return funds offering 10% to the investor.

Risky Business

Tencent is hardly alone in its investments in the credit markets,

³ <http://www.21cbh.com/2013/11-25/2NMzEOXzk1NTc2NA.html>

⁴ <http://www.21cbh.com/2013/12-26/xMMDAzMTZfMTAwODMxMg.html>

⁵ <http://www.laohucaijing.com/news/799.html>

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but, by making few disclosures, the company is misleading investors about the extent of their risk. While the core gaming business slowed in 2013, Tencent sought gains from high-interest lending. These loans are typically bridge loans while companies and individuals seek lower-priced loans from banks. At best, the loans' viability depends on continuing expansion of credit through the banking system—not a good bet in 2014. At worst, a portion of these loans may support Ponzi schemes, which promise new investors fixed returns over 10% and depend on the addition of new capital. The press reported the failure of at least 40 such online lending schemes in 2013.

Other Q4 Investments

On January 2, Tencent invested another USD 30 mln in “Didi Taxi”⁶ only seven days after the last round of financing, one week earlier, on Christmas 2013, “Didi Taxi” announced that it had received USD 100 mln from Tencent and CITIC PE; Didi did not disclose the split between the two.⁷ Tencent had invested USD 25 mln in Didi in the first round. We find the speed with which this 30 mln followed the 100 mln very suspicious. Either Didi is desperately in need of cash or, more likely, the transactions are masking some other financial arrangement.

Didi competes with Kuaidi Taxi, an Alibaba-invested taxi app and resembles the U.S. Uber. Given that this is a highly competitive area in China, that fees are usually less than USD 1, and that taxis in most cities are in over-supply, we believe that, unlike Uber, there is no clear path to profit for Didi.

On December 20, Tencent also participated in funding for Android ROM developer CyanogenMod, which makes an open-source firmware replacement for smartphones and tablets. CyanogenMod claims 11 mln monthly active users.⁸

Risks

1) Tencent's financial service businesses are legal and very profitable. Should Tencent manage to avoid the risks in China's financial sector, the investments could be positive for Tencent. 2) Didi could surpass Kuaidi and move to profit.

⁶ <http://www.techinasia.com/tencent-tips-100-million-funding-chinas-leading-taxihailing-app-wechat-integration/>

⁷ <http://www.36kr.com/p/208673.html>

⁸ <http://technode.com/2013/12/20/tencent-follows-23-million-series-b-financing-for-third-party-android-rom-developer-cyanogenmod/>

Table 1. Financials

Mln RMB	Dec-11A	Dec-12A	Dec-13F	Dec-14F	Dec-15F	Dec-16F	Dec-17F
Income statement							
Revenue	28,496	43,894	56,833	72,759	92,520	118,091	154,865
Internet value added service	23,043	31,995	41,019	50,576	59,875	67,944	74,738
Growth rate	49%	39%	28%	23%	18%	13%	10%
Gaming rev	15,482	22,849	29,704	37,130	44,556	51,239	56,363
Growth rate	66%	48%	30%	25%	20%	15%	10%
Gaming rev as % of IVAS	67%	71%	72%	73%	74%	75%	75%
Mobile value-added service	3,271	3,723	4,468	5,584	7,148	9,293	12,266
Growth rate	20%	14%	20%	25%	28%	30%	32%
Online advertisement	1,992	3,382	5,810	10,097	17,747	31,551	56,721
Growth rate	45%	70%	72%	74%	76%	78%	80%
E-commerce	0	4,428	4,871	5,358	5,893	6,483	7,131
Growth rate			10%	10%	10%	10%	10%
Others	190	365	665	1,145	1,855	2,822	4,009
Growth rate	153%	92%	82%	72%	62%	52%	42%
COGS	-9,928	-18,207	-25,280	-34,547	-46,704	-63,156	-87,469
COGS as % of sales	0	0	0	0	-1	-1	-1
Gross profit	18,568	25,686	31,553	38,213	45,815	54,935	67,396
Total operating cost	-6,314	-10,207	-14,824	-20,422	-27,814	-37,884	-52,834
Selling expenses	-1,921	-2,993	-4,444	-6,417	-9,085	-12,777	-18,305
Selling exp as % of rev	0	0	0	0	0	0	0
G&A	-5,283	-7,765	-10,623	-14,327	-19,143	-25,615	-35,141
G&A as % of rev	0	0	0	0	0	0	0
Other opex (income)	421	-284	-284	-284	-284	-284	-284
Interest income	469	836	527	606	698	792	895
Operating profit	12,254	15,479	16,729	17,791	18,001	17,051	14,563
EBITDA	12,315	16,691	19,131	21,435	23,537	25,468	27,338
Depreciation & amortisation	951	1,763	2,644	3,967	5,950	8,925	13,387
EBIT	11,364	14,928	16,486	17,468	17,587	16,543	13,951
Interest income/(exp)	36	-348	-130	-157	-191	-233	-287
Borrowing cost	-73	-327	-109	-136	-170	-212	-266
FX gains	108	-21	-21	-21	-21	-21	-21
Income from subsidiaries	-24	-54					
Income from JVs	-166	-26	-26	-26	-26	-26	-26
Profit before tax	12,099	15,051	16,573	17,608	17,783	16,791	14,250
Pre-tax profit	12,099	15,051	16,573	17,608	17,783	16,791	14,250
Taxation	-1,874	-2,266	-2,495	-2,651	-2,678	-2,528	-2,146

Effective tax rate	0	0	0	0	0	0	0
Profit after tax	10,225	12,785	14,078	14,957	15,106	14,263	12,104
Minority interests	-22	-53	-53	-53	-53	-53	-53
Other adjustments							
Net profit	10,204	12,732	14,025	14,904	15,053	14,210	12,051
Recurring profit	10,204	12,732	14,025	14,904	15,053	14,210	12,051
	0	0	0	0	0	0	0
Balance Sheet							
Mln RMB	Dec-11A	Dec-12A	Dec-13F	Dec-14F	Dec-15F	Dec-16F	Dec-17F
Non-current assets							
Property	5,885	7,403	13,241	19,862	29,793	44,689	67,033
Construction in process	159	534	357	535	803	1,205	1,807
Investment in property management	22	22	22	23	24	24	25
Land use right	231	794	520	779	1,169	1,754	2,630
Intangible assets	3,780	4,719	8,675	11,834	15,973	21,569	29,835
Investment in subsidiaries	4,338	7,310	9,789	13,259	17,785	23,882	32,868
Investment in JV	62	35	36	36	36	37	37
Deferred Tax assets	198	169	174	179	185	190	196
Hold to maturity	0	0	0	0	0	0	0
Available for sale financial assets	4,344	5,633	5,633	5,633	5,633	5,633	5,633
Other long term assets	2,283	1,236	1,236	1,236	1,236	1,236	1,236
Long term deposits	0	10,892					
Total Non-current assets	21,301	38,747	39,683	53,377	72,637	100,219	141,300
Inventory		568					
Account receivable	2,021	2,354	3,410	4,002	4,626	5,314	6,195
Prepayments, deposits and other assets	2,212	3,878	5,115	6,912	9,252	12,400	17,035
3-month term deposit	13,716	13,806	13,442	13,173	13,173	12,909	12,909
Restricted cash	4,943	2,520	3,757	4,246	4,798	5,422	6,126
Cash and cash equivalent	12,612	13,383	17,928	23,019	28,568	34,471	40,663
Total current assets	35,503	36,509	43,652	51,352	60,417	70,516	82,929
Total assets	56,804	75,256	83,335	104,729	133,054	170,734	224,229
Non-current liabilities		0	0	0	0	0	0
Borrowings		2,106					
Bill payable	3,733	7,517	7,517	7,517	7,517	7,517	7,517
DTL	940	1,312	1,312	1,312	1,312	1,312	1,312
Account payable	1,860	1,509	1,509	1,509	1,509	1,509	1,509
Total Non-current liabilities	6,533	12,443	10,337	10,337	10,337	10,337	10,337
Account payable	2,244	4,212	6,473	9,363	13,359	19,012	27,643
Other account payable	5,014	6,301	13,779	19,521	27,325	38,213	54,674
Derivatives	21	0	0	0	0	0	0
Short-term borrowings	7,999	1,077	11,996	14,995	18,744	23,430	29,287
Tax payables	709	420	1,193	1,400	1,548	1,588	1,455

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Other tax payables	179	540	225	239	214	177	129
Deferred sales	5,016	8,115	9,093	11,641	13,878	17,714	23,230
Total current liabilities	21,183	20,665	42,759	57,160	75,068	100,134	136,417
Equity							
Share capital	0	0	0	0	0	0	0
share surplus	123		0	0	0	0	0
Share option plan	-607	-667	-667	-667	-667	-667	-667
Bonus reserve	1,935	2,880	2,880	2,880	2,880	2,880	2,880
Other reserve	302	816	816	816	816	816	816
Retained earnings	26,710	38,269	29,782	38,499	46,582	63,434	63,434
Minority interest	625	851	851	851	851	851	851
Total equity	29,088	42,148	30,239	37,232	47,649	60,263	77,474

Source: Company data, J Capital Research.

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