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TENCENT

Upstream Growth Abounds

Tencent Holdings Limited (SEHK 0700), a leading provider of Internet value added services in China, is the biggest gaming company (by revenue) in the world. In 2004, Tencent Holdings Limited (SEHK 700) went public on the main board of the Hong Kong Stock Exchange. In 2016, with a 48% increase in total revenue (\$21.903 billion), Tencent became the 10th largest publicly traded company in the world. Furthermore, Tencent holds a significant amount of stake in other giant companies: 15% stake of JD.com ((NASDAQ:JD), one of largest B2C online retailers in China), 5% stake in Tesla (NASDAQ:TSLA) and 12% in Activision Blizzard (NASDAQ:ATVI), the third-largest gaming company in the world.

Key Points:

- Tencent has obtained patents relating to the technologies in various areas: instant messaging, e-commerce, online payment services, search engine, information security, gaming, and many more.
- Business culture is committed to the satisfaction of users' needs by providing innovative internet-based services.
- As a strategy for its long term development, Tencent significantly invests in R&D. In 2007, it set up China's first Internet research institute

Outlook

Tencent has planned increasing investments in every business unit. In particular, it will be focused on improving efficiency of customer lifecycle management for retailers, providing more personalized services for customers and enhancing user targeting and product recommendation using offline data.

STRONG BUY

Price: \$ 51,40 (16/04/2018)
Target Price : \$ 60,81

Key Statistics:

52 week average: \$29,24 - \$61
Shares outstanding: 9,5 B
Market cap: 3.743.396

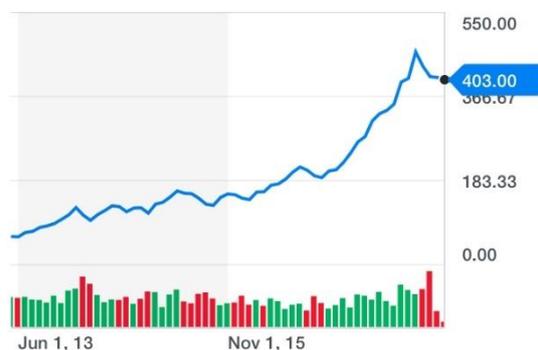
Scenario Analysis



Profile:

Sector: Technology/ Software & Computer services
Industry: Value Added Online Services
CEO: Ma Huateng
Haedquarter: Shenzen

Tencent 5Y Price Performance (HKD)





Business & Group overview

Founded in November 1998, Tencent Holdings Limited (SEHK 0700) is a leading provider of Internet value added services in China as well as the biggest gaming company (by revenue) in the world. Since its establishment, Tencent has continued growing steadily thanks to its business philosophy that mainly focuses on users' needs.

In 1999, Tencent launched OICQ, an instant messaging software, that was its first major success and grew exponentially thanks to satisfying response from the users. However, some copyright complaints pushed Tencent to change its instant messenger name to 'QQ'. Four years later, the firm launched the web portal of QQ, which provides innovative information services, and in the same year entered the online games market.

On June 16, 2004, Tencent went public on the main board of the Hong Kong Stock Exchange, thus increasing its profits. Only four years later it became a constituent of Hong Kong's Hang Seng Index. In 2013, Tencent market capitalization reached US\$ 100 billion and in 2016 it became the 10th largest publicly traded company in the world, with a 48 per cent increase in total revenue. Furthermore, Tencent holds shares of other giant companies: 15% stake of JD.com (NASDAQ:JD), one of largest B2C online retailers in China), 5% stake in Tesla (NASDAQ:TSLA) and 12% in Activision Blizzard (NASDAQ:ATVI), the third-largest gaming company in the world.

As of March 31, 2017, the monthly active user accounts of QQ was 861 million while its peak concurrent user accounts reached 266 million. Combined MAU of Weixin and WeChat was 938 million.

Over the following years, Tencent has broadened the range of internet-based services provided and introducing also payment services linked to its instant messaging software. Nowadays, Tencent operates in four segments: social networks (QQ, Weixin, Qzone), payment (Tenpay, Weixin Pay, QQ Wallet), entertainment (Tencent Game, QQ Music, NOW Live, Interest Tribe, Tencent classroom, Nextradio) and information (QQ.com, Tencent News, Tencent Video, Tencent Microblog).

All the services provided by Tencent are compliant with the its business philosophy, which aims to the enhancement of the quality of human life through innovative Internet services. Indeed, Tencent's online platform have favoured the cohesion of the Chinese community. In particular, the development of Tencent has significantly influenced the ways hundreds of millions of Internet users communicate with one another as well as their lifestyles.

Tencent's success is the result of huge efforts directly aimed to innovation. As a



consequence, the firm continues to feed its growth by focusing on innovation. Indeed, more than 50 per cent of Tencent employees are members of the R&D division. In 2007, Tencent set up China's first Internet research institute, called Tencent Research Institute, whose campuses are in Beijing, Shanghai, and Shenzhen. The institute focuses on the development of core Internet technologies aiming to pursue its development and innovation for the industry. This strategy for the long term development has allowed Tencent to strengthen its brand even outside China. Furthermore, Tencent is widening its social commitment by participating in public charity programs and promoting several public charity projects in China. In particular, Tencent was the first Chinese Internet enterprise to set up a charity foundation when it inaugurated the Tencent Charity Fund in 2006 and, later, the public charity website gongyi.qq.com, that is committed to youth education and assistance to poorest communities.

Income Statement's assumptions

Income Statement	2013	2014	2015	2016	2017E	2018E	2019E
Value-added services	7.262,83	10.301,49	12.958,26	16.235,65	19.304,18	22.971,98	27.566,38
Online advertising	812,74	1.351,84	2.805,97	4.061,55	4.829,18	5.746,72	6.896,07
eCommerce transactions	1.581,56	773,38	0,00	0,00	0,00	0,00	0,00
Others	100,42	416,71	759,16	2.583,91	3.072,27	3.656,00	4.387,20
Total operating revenues	9.757,55	12.843,42	16.523,40	22.881,10	27.205,63	32.374,70	38.849,64
Cost of revenues	-4.484,76	-5.023,50	-6.687,40	-10.155,98	-11.984,05	-14.141,18	-16.686,59
Selling and marketing expenses	-919,46	-1.268,69	-1.283,96	-1.827,62	-2.193,15	-2.631,77	-3.158,13
General and administrative expenses	-1.612,56	-2.303,23	-2.702,68	-3.382,21	-4.058,66	-4.870,39	-5.844,46
Total operating costs	-7.016,78	-8.595,42	-10.674,04	-15.365,81	-18.235,85	-21.643,34	-25.689,19
Interest income	212,15	272,71	373,80	394,41	402,30	410,34	418,55
Other (losses)/gains, net	145,95	448,93	302,96	541,24	552,06	563,10	574,37
Net non-recurring revenues	358,10	721,64	676,76	935,65	954,36	973,45	992,92
EBIT	3.098,87	4.969,64	6.526,12	8.450,94	9.924,14	11.704,81	14.153,37
Cost of revenues	-13,56	-192,33	-259,91	-294,41	-353,30	-423,96	-508,75
Share of losses os associated and joint ventures	27,61	-56,46	-448,65	-379,80	-455,76	-546,91	-656,30
Net financial revenues	14,05	-248,79	-708,56	-674,21	-809,06	-970,87	-1.165,04
Income before taxes ⁽²⁾	3.112,92	4.720,85	5.817,56	7.776,73	9.115,08	10.733,94	12.988,33
Total income taxes	-600,27	-833,91	-1.141,79	-1.535,01	-1.823,02	-2.146,79	-2.597,67
NET PROFIT	2.512,65	3.886,94	4.675,76	6.241,71	7.292,07	8.587,15	10.390,66

The average growth rate of profit before tax for the past 5 years is 36%, which shows Tencent is at its early stage instead of a mature company. According to the latest ranking of mobile games, five of top 10 most profitable ones are run by Tencent. As the main source of income, the strong performance of Tencent Games ensures the increasing contribution to the Group profit.

Due to several new capital investments in other internet and media companies such as Weipinghui (online retailer, 8.63bn USD invested jointly with Jingdong, another large online retailer in China) and New Classics Media (media producer, 3.3bn RMB, shareholdings transferred by Beijing Enlight Media Co.), the composition of Tencent Group is more complex and diversified. However, the growth in these new areas is slower than pre-existing business units. Therefore, the growth rate of pre-tax profit is assumed to be decreasing from 36% to 31% for the following 5 years.

Tencent's core business units cover 7 of top 10 Internet appliances such as social media

and communication (WeChat), online games (Tencent Games) and media and digital content (eg. Tencent video) and they are all considered as consumer-based services. By the end of 2017, there are 772 million internet users in China, accounting for 55.8% of the whole population and increasing steadily at around 3% each year. This trend provides Tencent a strong and stable growing point in the long run.

Since 2012, the inflation rate firstly went down from 2.65% to the bottom of 1.44% in 2015 and climbed up to 2% in 2017. It is estimated to be 2.2% in 2018, 2.6% in 2019 and 3% constant for 2020 and onwards.

Based on the macro factors discussed above, the constant growth rate for the terminal value is assumed to be 28%, given the overall industrial one is 18% derived from the fact that the total digital industry mainly driven by the Internet was reported to be growing at 18.9% in 2016.

Financial Ratios

Tencent has increased its sales at a fast rate from 2013 to 2016 with a maximum of 40% and 38% respectively in the first and final year considered. The sales growth rate is assumed to be increasing in the next three years from 18,9% to 20%. Therefore, we prospect a lower increasing rate in some sectors in which the company operates. For example, after the Olympics game (2016) there will be a decrease deriving from the news ad revenue. While Smart phone games and video platform will continue to boost the ad revenues of Tencent.

Development Ratios	2013	2014	2015	2016	2017	2018	2019
Sales growth	40,31%	31,63%	28,65%	38,48%	18,90%	19,00%	20,00%
Net Income growth rate	24,04%	54,69%	20,29%	33,49%	16,83%	17,76%	21,00%
Cost of Goods growth rate	55,46%	12,01%	33,12%	51,87%	18,00%	18,00%	18,00%
Invested Capital Growth rate	46,05%	175,49%	-8,77%	220,08%	33,85%	33,13%	33,96%

Looking at the development ratios, it's evident how also the cost of goods have raised from 2013 to 2016 with higher volatility and we prospect a steady growth (18%) from 2017 to 2019. Furthermore, there have been a huge rise in the invested capital from 2013 to 2016, with important plans of development in different business areas, with a special focus on managing original content production (new revenues generated from the spread of interest in China Literature). A growth rate of around 33% is prospected for the next three years.

Profitability Ratios	2013	2014	2015	2016	2017	2018	2019
ROE	26,86%	29,86%	24,25%	23,73%	21,92%	20,21%	18,95%
ROIC	34,97%	38,81%	27,69%	24,41%	18,46%	17,49%	16,72%
EBIT margin	42,67%	48,24%	50,36%	52,05%	51,41%	50,95%	51,34%
Asset turnover	81,96%	80,45%	54,98%	46,89%	35,92%	34,32%	32,57%

Considering the profitability ratios, there is a strong evidence of the good state of the company with high and stable ROE (23,73% in 2016) which will continue to be above the mean of the sector (17,21%) even in the three years forecasted. The increasing trend in the EBIT margin (from 42,67% to 52,05%) shows the high profitability of the businesses of Tencent which will continue to increase in the next years. Margins are high especially from add revenues while there is more difficulty at generating high profit from cloud.

The potential of the company is high if we look at the leverage used to generate profits

since the ratio D/E is currently 0,14. Our view for the next year is that there will be a rise in the use of debt with an increase of the leverage of 0,38 in 2017.

VALUATION – DCF ANALYSIS

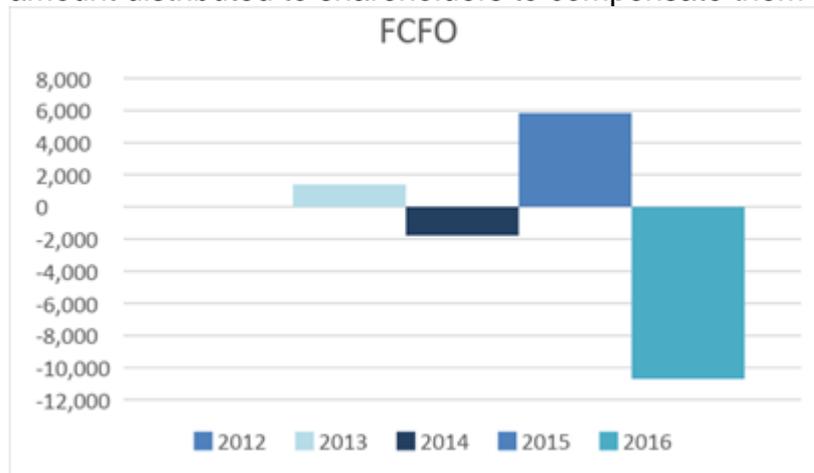
The preparation of financial statements in conformity with IFRSs requires the use of certain critical accounting estimates and judgements. We want to stress that we used medium exchange rates to convert the values in US Dollars to have the comparability with other companies (in order to make an appropriate comparable analysis).

As we can see from the Cash Flow Statement there's cash generation in 2013,2014 and 2015 while in 2016 we note a consistent decrease in Cash. This 2016 trend is determined for the biggest part by the cash absorbed by the change in Working Capital. This reduces the FCFO but the negative value is partially reduced thanks to debt that increases and is a signal of cash disposal.

We can see from the graph the FCFO of the company and we can analyze the cash flows used to determine the Enterprise Value.

The generation of Operating Cash Flow does not follow a regular trend and this is due to the fact that the company is in a positive phase, and it shows a lot of investments. Indeed we see an increasing Capex during the period analyzed.

Another point to underline is the dividends' distribution policy. Every year they increased the amount distributed to shareholders to compensate them for their commitment.



FCFE follow quite regularly the same trend of FCFO, with an exception in 2014 due to the consistent increase in gross debt.

Analyzing Gross Cash Flows we can see a significant growth, this means Tencent is always able to finance other expenses after the non cash-ones. As a conclusion we delineate an interesting profile in term of generation of cash flows and capacity to finance operational flows.

We see big potential of expansion for the company and for the sector in general. Tencent is in a good phase of development: great investments, availability of debt from the financial system and interesting shareholders remuneration.

The valuation is developed through DCF and cash flow analysis. We highlight historical data on which we based our analysis. In particular, we give evidence on EBITDA (calculated as EBIT + D&A, where D&A are estimated with the conversion factors used also for the Balance



Sheet and Income Statement analysis). Other information comes from the Reorganized Cash Flow Statement.

Historical data	2013	2014	2015	2016
EBITDA	3.845,87	5.764,64	7.710,12	10.209,94
Taxes	-600,27	-833,91	-1.141,79	-1.535,01
Working Capital	-3.077,72	-5.395,14	-14.814,88	-8.798,06
CAPEX	-1.998,02	-7.803,85	-3.396,95	-3.779,68
FCFO	1.407,69	-1.777,36	5.837,08	-10.705,93

Thanks to the forecasted data we can calculate the Present Value for years 2017-2019 and then we estimated the Terminal Value for the following years. The TV is given by the actualized normalized FCFO (calculated considering 2019 Operating Income, Taxes and Maintenance Investments) which is actualized considering the difference between WACC and growth rate.

All cash flows are actualized using WACC (15%).

In terms of discount rate, levered WACC is estimated to be 15%. According to the dividend capitalization method, the cost of equity is 30.19% with the dividend growth rate estimated to be 30% based on historical data. COE is calculated to be 36.3% in 2017 based on CAPM model with the beta of 1.01 provided by Yahoo Finance and interest rate of 1.5%. Therefore, the onward COE is adjusted to 30% for WACC calculation. The average historical cost of debt is 1.03%. there is no foreseen significant change in interest rate or capital structure. Due to the complex of tax systems applied to Tencent and its subsidiaries (explained in detail in annual reports of the Group), an average tax rate of 20% is used in calculation of WACC. Along with the financial position disclosed in the annual report, the projected discount rate is 15%.

Forecasted data	2017	2018	2019	TV
Year	1	2	3	4 to 25
EBITDA	12.034,94	14.237,77	17.192,92	
Taxes	-1.823,02	-2.146,79	-2.597,67	
Working Capital	-8.974,02	-9.171,45	-8.960,24	

CAPEX	-555,89	-665,00	-808,60	
FCFO	-1.954,09	-2.492,44	-2.467,32	87.463,56
PRESENT VALUE	-1.699,21	-1.884,64	-1.622,30	583.090

TV calculation	
Normalized FCFO	14.555,70
EBIT	14.153,37
TAXES	-2.597,67
Maintenance investments	3.000,00
TV	87.463,56

The EV (the sum of present values) is USD 577.884,22.

The price we obtain considering the number of outstanding shares (9,5 billions) is **\$60,81**.

The best scenario (price: USD 80,60) considers an increase of 0,25% for the growth rate and a decrease of 0,50% for WACC. The worst scenario considers an increase of 0,50% for WACC and a decrease of 0,50% for the growth rate (price: USD 45,35).

We calculate the price using comparables companies and their multiples to complete our analysis.

VALUATION – MULTIPLES

Competitor	Country	Currency	Market (bln)	Net debt (bln)	Enterprise value (bln)
Alibaba Group	China	USD	450.584	5.660	456.244



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Facebook	United States	USD	483.160	2.098	485.258
Netease	China	USD	36.981	3.261	40.242

	EV/EBITDA2017	EV/EBIT2017	P/E 2017	EV/SALES 2017
Alibaba Group	42,18	49,03	75,24	19,84
Facebook	20,89	24,02	30,32	11,94
Netease	19,92	21,21	22,18	4,84
Average	27,66	31,42	42,58	12,21
Median	20,89	24,02	30,32	11,94
Size discount	0,56	0,56	0,56	0,56
Average	12,17	13,83	18,73	5,37
Median	9,19	10,57	13,34	5,25

	EV	Price
EV/SALES	494533	52,06
EV/EBITDA	509684	53,65
EV/EBIT	462336	48,67
Mean	488851	51,46



Conclusion

The Chinese tech company shows a strong capability at operating in high profit margin business areas which permit to developing at a fast rate. It maintains many advantages in the communication sector through its main drivers Weixin & Wechat due to its strong smart phone community. Furthermore, there is a spread interest in the community of QQ due to its live broadcast service for game videos.

The key advantages of the company derived from its leader position in China as mobile game developer and multiplayer online battle arena (MOBA) such a position was achieved thanks to its capability of converting popular licensed third-party PC games to mobile games.

We estimated the price with two different methods and we obtained 52,07 and 51,46. If we consider multiples analysis we can see how Tencent is undervalued considering comparable companies. Our conclusion is therefore to BUY Tencent's shares. The Chinese company is expected to face a consistent growth and, in the near future, no one will be able to overcome Tencent's performance.

Target Price is USD 60,81 (+19,10%).

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