From: "Barrett, Paul S" <[redacted]>
To: Jeffrey Epstein <jeevacation@gmail.com>, Richard Kahn <[redacted]>
Subject: FW: Tencent: Smartphone games and video subscription lead to better earnings outlook
Date: Thu, 11 May 2017 11:40:07 +0000
Attachments: Tencent_AY.pdf; image1.gif

JPM-pp1

Asia Pacific Equity Research

Tencent: Smartphone games and video subscription lead to better earnings outlook

Overweight

We turn more positive on Tencent's financial outlook in 2017 and beyond due to: 1) better smartphone games outlook in 2017 especially due to outperformance of Honor of Kings, and 2) improving long-term outlook of video business. We expect Tencent Video to close the gap with iQiyi in terms of revenue and subscriber size in the next few years. We believe its key competitive strengths lie in: 1) rich IP reserves across all major entertainment categories (e.g. online games, literature and comics, etc.), which is synergetic to original video content production, and 2) distribution power. We estimate Tencent Video to achieve breakeven in 2019 and deliver 5.5% OPM in 2020.

- **Paid subscribers to reach 172m in 2020, with 4-year CAGR of 55%.** We estimate Tencent Video's subscribers to grow at a 4-year CAGR of 55% to 172m in 2020 (vs 182m for iQiyi and 117m for Youku), with a 74% penetration rate against China's total video subscribers of 234m. It will also represent 69% of China cable TV users and 46% of broadband users in 2020. We estimate the revenue contribution from subscription business to increase from 29% in 2016 to 76% in 2020.

- **Expecting Tencent Video to achieve breakeven in 2019.** We forecast Tencent Video's total revenue to grow at FY16-20E CAGR of 52% to RMB40bn in 2020. By leveraging its extensive in-house IP resources, we estimate the content cost as % of revenue to trend down from 80% in 2016 to 64% in 2020.

- **Smartphone games continue to deliver upside surprise.** We believe that Honor of Kings, the recent hit mobile game of Tencent, continued its momentum in 1Q17. We expect the game to generate RMB6-7bn/RMB20bn+ gross revenue in 1Q17/2017.

- **Maintain OW and revise up PT to HK$275**. We tweak up our non-GAAP EPS forecasts for 2017/18 by 4%/3% due to: 1) stronger mobile gaming outlook, and 2) better video margin outlook. Our PT is based on 2017E non-GAAP EPS of HK$7.54, a 2017E-19E EPS CAGR of 30% and a PEG of 1.2x, and implies a 2017/2018E P/E of 36x/27x.

Click **here** for the full Note and disclaimers.

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