Tencent Holdings (SEHK 700; ADR TCEHY): Results Snapshot, 2Q19 (Apr-Jun)

EARNINGS TAKEAWAYS

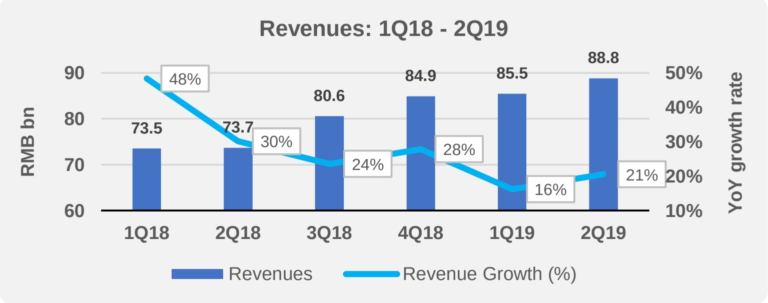
BRIGHT SPOTS

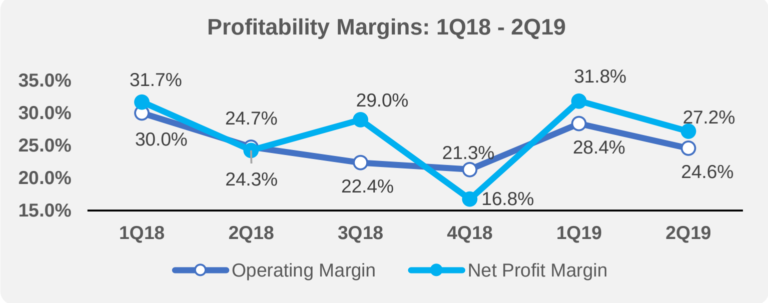
- Online gaming business: Tencent's top line engine staged a slight recovery as the Chinese government eased its clampdown on online gaming and license freeze imposed last year
  - It posted RMB27.3 billion, up by 8 percent YoY in 2Q19 vs. a decline of 1 percent YoY in 1Q19, accounting for just over a third of Tencent's total top line.
  - Reduced regulations saw launch of 10 games in 2Q19 vs. just one game in 1Q19.
- The "FinTech and Business Services" segment, which includes the cloud business, rose 37 percent in 2Q19 YoY, to post RMB22.9 billion in revenues.

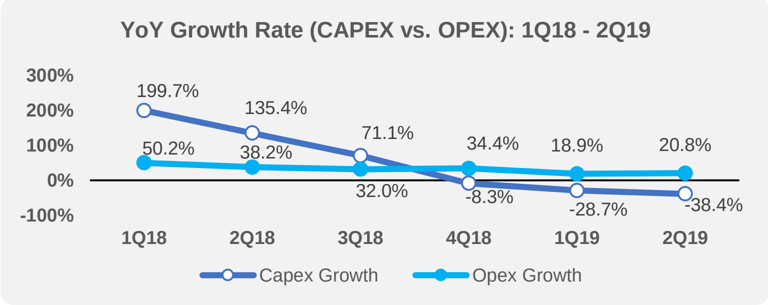
AREAS OF CONCERN

- Tencent's online advertising business witnessed a growth slowdown amid a tough macro environment
  - Online advertising revenues were up 16% YoY in 2Q19 vs. 25% in 1Q19
  - Tencent expects macro impact to persist in the second half of 2019, adding further pressure on the ads business.
- Competition from new rivals such as ByteDance (TikTok owner) is denting margins.
- Capex continues its downward journey for the sixth straight quarter in terms of YoY growth, and as a % of revenues.

EARNINGS OVERVIEW







Top line growth tops 20% levels, but falls short of hopes

- YoY revenue growth breached 20% in 2Q19 driven by "Online Games" and "FinTech & Business Services", putting 1Q19's slowdown concerns at bay for now.
- Despite this, 2Q19 top line of RMB88.8 billion ($12.9 billion) trailed Bloomberg consensus forecasts of RMB93.4 billion.
- Fintech and cloud services unit will be key in the near term as Tencent looks to diversify into market segments that are less prone to regulatory curbs and macro/geopolitical risks.
- Online advertising, a key business of Tencent, is facing growth challenges as China's advertising market is encountering slowdown – another reason why Tencent could be betting big on Fintech and cloud in the coming quarters.

Margins dip slightly – courtesy, a new rival and macro risks

- Though still in strong double-digits, both operating and net margins slipped in 2Q19 (versus 1Q19).
- Increased content costs for products and services, including live broadcast and video streaming subscriptions, is one key reason for the margin dip. Costs could go up further in the coming quarters with the emergence of a new and tough rival in ByteDance, stoking further pressure on margins
- Content and traffic acquisition costs for the online advertising business also weighed down margins - this could further dent margins going forward as Tencent expects macro risks to impact the online ads business in the second half of 2019.

Capex decline remains stubborn

- Capex spending declines continued in 2Q19. Tencent's capex to sales ratio is now well below Alibaba & Baidu
- Tencent's capex pays for data center construction, corporate facilities, and network equipment. Its network supports 25 cloud regions and over 1 billion messaging users.
- Tencent is looking to turn its cloud business into the next growth-engine, as other units (online gaming and advertising) face external risks. As the cloud business requires heavy capex investments, Tencent will likely be faced with significant capex growth going forward.
- Opex growth, on the other hand, is relatively steady and driven by increased spending on R&D and content.

Source: Company quarterly reports; MTN Consulting (see https://www.mtnconsulting.biz/)