

Demonstrating sustainable growth**China Internet****Tencent (700 HK, HK\$16.90)****Not Rated**

Online advertising the main surprise in seasonally slower 2Q. Tencent's 2Q FY12/06 results came in as expected. Turnover was up 111.3% YoY and 9.2% QoQ to RMB 705.0m, while operating profit surged 161.1% and 10.1% QoQ to RMB310.0m. Net profit of RMB267.9m represented only a 43.3% YoY increase as a recognition of deferred tax asset amounting to RMB88.6m inflated the bottom line a year ago. The main surprise was online advertising, where sales surged 150.2% QoQ to RMB63.0m. Internet value added services (IVAS) revenues was solid in a traditionally slow 2Q, growing 5.9% QoQ to RMB462.3m, while wireless value added services (WVAS) added RMB178.4m, up 9.1% QoQ.

Margins were solid. Gross margins for individual segments were solid taking into consideration seasonal factors. IVAS, WVAS recorded gross margins of 77.1% and 63.1%, down 1.2 pcp and 0.3 pcp QoQ respectively. Off a larger revenue base, online advertising gross margin surged 5.8 pcp QoQ to 65.7%. Operating margin for the company improved 0.4 pcp QoQ to 44.0%.

Online advertising growth not all due to World Cup. Unlike its peers, which attributed 2Q advertising growth mainly to the World Cup, Tencent's growth during the quarter was the result of a shift in strategy from direct sales to partnering advertising agencies together with increasing popularity of its flagship portal. QQ.com is now China's no. 1 ranked internet portal according to Alexa.com. Advertising sales on QQ.com surged 118.3% QoQ to RMB26.4m as the company secured a key client in Coca-Cola. Management indicated that advertising contribution from the World Cup was not significant, amounting to "a few million RMB". We believe that QQ.com's rise in popularity is a direct result of the network effect derived from its 224.2m active IM user base. The company is now beginning to tap the burgeoning online advertising industry and now enters the seasonally stronger 2H, we expect the segment to sustain its solid growth momentum, though moderating from the triple digit QoQ growth recorded this quarter. The increased advertising contribution will also lessen the pressure to monetize its user base.

Games impacted by seasonal factors, pipeline is solid. With the majority of QQ's user base 25 years and under, the school exams/holidays season, coupled with the World Cup, impacted time based usage products such as online games. Active concurrent users (ACUs) on its casual game portal, QQGame, fell 0.2m QoQ to 2.6m, while ACUs for QQFantasy dropped 22.3% QoQ to 99k. In our view, the ACU decline in the MMOG was exacerbated by the delay in the launch of its expansion pack. We believe management may have deliberately timed the re-invigoration of QQFantasy according to roll out schedules of new MMOGs by its competitors. The expansion pack was finally launched on 19 Aug. Going forward, Tencent's gaming pipeline is solid. It is currently open-beta-testing advance casual game R2Beat and works with Shenzhen Domain to develop new MMOG Huaxia2. We are favourable on Tencent's broad game portfolio, which includes casual games (41), advance casual games (2) and MMOGs.

IVAS diversification ongoing. Tencent's IM platform grew healthily during the quarter and was the primary driver of IVAS revenue gains. Fee based IVAS subs rose 8.9% QoQ to 14.7m while average daily user hours and messages rose 10.8% and 15.6% QoQ to 301.7 hrs and 3,334.1m messages. The company is investing heavily to enrich users' IM experience. The company has launched beta version 2 of QQ2006, featuring shared blogs and enhanced online chat as well as bundled increasing services into its QQ membership packages. Meanwhile, the company is continuing its strategy to limit daily activation of other fee paying services such as QQPet and QZone, instead focusing on improving product quality. We note that 74.7% of opex increase during the quarter was attributed to R&D expenditure.

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WVAS uncertainty ahead, but impact limited. The stronger than expected WVAS revenues this quarter was driven by a 46.7% QoQ increase in its 2.5G services (RMB21.6m). This segment will be an underperformer going forward with the regulatory changes in the WVAS industry. However, we argue that the negative impact on the company's over earnings will be limited. Over the past year, Tencent has successfully reduced its reliance on WVAS to 25.3% of overall revenues from 40.9% a year ago. We expect this percentage to fall to around 15% by year end. In our view, we believe that it is more important for Tencent to retain and continue the Mobile Chat service with China Mobile (941 HK, HK\$50.05, NR) as it forms an extension to its IM experience.

Opex increases not a significant concern in our view. Management indicated that they expect to increase headcount to 3,000 by year end, from 2,443 at the end of 2Q FY12/06. We are not overly concerned on the aggressive expansion strategies as our forecast model suggests that revenue growth will track ahead of opex growth over the long term. However, we expect to see opex increase as a percentage of revenues going into 3Q FY12/06 as we project a jump in headcount as the company takes on many university graduates. Meanwhile, with some residual World Cup effects in July, we do not expect affected IVAS services such as QQGame and QQFantasy to commence rebound until the middle of the quarter. This, together with diminished WVAS contribution, may slightly blunt revenue growth momentum in 3Q.

Most diversified Internet play. Tencent is the most diversified company on China's Internet space. Moreover, its broad product portfolio, including online identities (QQ IM), virtual pets (QQPets), community sites (Qzone), WVAS, and online games serves to reinforce cross selling opportunities, product bundling without inter-segment revenue cannibalization. Management is solid, recognizing the importance of community participation to the overall success of its platforms and mindful not to over monetize its user base.

Revised preliminary forecasts. We have revised up our FY12/06F net profit up slightly to RMB1,091.9m (EPS: RMB0.614) from RMB1,075.4m after incorporating higher contribution from online advertising and adjusting for opex structure changes and a slight decrease in effective tax rate. Thereafter, we expect the bottom line to further grow 26.8% and 34.4% YoY to RMB1,384.4m in FY12/07F and RMB1,860.1m in FY12/08F respectively.

Valuation. Tencent is currently trading at 28.6x FY12/06F and 22.7x FY12/07F P/E compared to an average of 33.1x and 25.6x for the industry comparables.

Table 1: 2Q results

3 months to June	Turnover (RMBm)	Gross profit (RMBm)	Gross margin (%)	Operating profit (RMBm)	Tax rate (%)	Net profit (RMBm)	Basic EPS (RMB)
2Q06	705.0	505.9	71.8	310.0	11.7	267.9	0.151
2Q05	333.7	224.7	67.3	118.8	na	187.0	0.106
YoY (%)	111.3	125.2	4.5	161.1		43.3	42.4

Source: Company data

Table 2: Segment gross margins

Gross margin (%)	1Q05	2Q05	3Q05	4Q05	1Q06	2Q06
WVAS	62.7	65.9	63.5	61.4	63.6	63.1
IVAS	71.4	68.9	69.8	71.8	78.3	77.1
Online advertising	60.9	72.9	72.5	67.0	59.9	65.7

Source: Company data

Table 3: Valuation comparisons

Company Name	Ticker	Yr End	Mkt Cap (US\$m)	Price	Cur Yr P/E (x)	Next Yr P/E (x)
Sina	SINA US	Dec	1,247.5	US\$23.27	32.7	26.9
Sohu	SOHU US	Dec	803.5	US\$21.67	31.0	23.3
Netease	NTES US	Dec	2,208.2	US\$16.84	15.0	13.5
Ctrip	CTRP US	Dec	1,611.4	US\$50.47	53.7	38.7
Average					33.1	25.6
Tencent	700 HK	Dec	3,811.4	HK\$16.90	28.6	22.7

Source: Bloomberg

Table 4: P&L

Year to Dec (RMBm)	03A	04A	05A
Turnover			
WVAS	467.4	641.2	517.3
IVAS	229.7	439.0	786.7
Online advertising	32.8	54.8	112.8
Others	5.1	8.5	9.6
	735.0	1,143.5	1,426.4
% chg	179.3	55.6	24.7
Cost of sales	(229.5)	(418.1)	(469.9)
Gross profit	505.4	725.4	956.5
Other operating income, net	(1.2)	25.9	73.1
Selling and marketing expenses	(56.0)	(109.5)	(197.6)
General and administrative expenses	(112.0)	(173.1)	(347.7)
Operating profit	336.2	468.7	484.4
Finance costs	2.0	(5.0)	(47.3)
Profit before taxation	338.2	463.7	437.1
Tax	(16.0)	(22.5)	48.3
Profit after taxation	322.2	441.1	485.4
Minority interests	-	-	-
Profit attributable to shareholders	322.2	441.1	485.4
% chg	129.0	36.9	10.0
Dividend	(28.9)	(113.0)	(147.5)

Source: Company data

Table 5: Quarterly breakdown

Year to Dec (RMBm)	3Q05A	4Q05A	1Q06A	2Q06A
Turnover				
WVAS	121.2	125.3	163.4	178.4
IVAS	204.7	263.1	436.5	462.3
Online advertising	34.7	37.7	41.8	63.0
Others	2.3	3.3	3.6	1.4
	362.8	429.4	645.3	705.0
% chg	8.7	18.4	50.3	9.2
Cost of sales	(118.8)	(140.2)	(175.7)	(199.0)
Gross profit	244.0	289.3	469.6	505.9
Other operating income, net	16.0	30.1	21.5	21.4
Selling and marketing expenses	(51.6)	(62.0)	(79.7)	(74.8)
General and administrative expenses	(91.2)	(112.4)	(129.8)	(142.4)
Operating profit	117.2	145.0	281.6	310.0
Finance costs	(42.4)	(4.8)	(10.1)	(6.5)
Profit before taxation	74.9	140.2	271.5	303.5
Tax	2.9	(16.5)	(21.8)	(35.6)
Profit after taxation	77.8	123.7	249.7	267.9
Minority interests	-	-	-	-
Profit attributable to shareholders	77.8	123.7	249.7	267.9
% chg	(58.4)	59.1	101.9	7.3
Dividend	-	-	-	-

Source: Company data