Why You Should Buy Tencent Holdings

Aaron Bush and David Gardner | September 27, 2017 | Buy Recommendation

CURRENT PRICE: TCEHY $ 62.75 -$ 0.24 (-0.4%)

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Chinese Internet titan **Tencent Holdings** (NASDAQOTH: TCEHY) isn't like most gigantic companies. If all you saw was its $400 billion market cap, you might be tempted to file it away as a successful business whose growth has probably run its course. The reality is almost the opposite: Tencent comprises a handful of great businesses whose best days may still be ahead of them.

Tencent was founded in 1998 by a group of technologists, including Pony Ma, who's still CEO today. The project that first broke it into the mainstream, the messaging service QQ, is still popular almost 20 years later, and Tencent has used its gains to transform the entire company. Between an incredible gaming operation, a monopoly in social media, a fantastic collection of other services and content, and a growing suite of investments, we think Tencent can keep rewarding shareholders for years. Dig in with us and we think you'll find room for this giant in your portfolio.

WHAT IT DOES

Tencent is a Chinese Internet titan. It runs the largest gaming enterprise worldwide, dominates the Chinese social media scene, and holds investments in numerous companies around the globe.

WHY BUY

- Tencent is large, yet still displaying promising growth on all fronts.
- The company generates enormous cash flows, which it reinvests into interesting opportunities.
- A monopoly in WeChat creates a competitive advantage that should last for many years.

3 THINGS TO KNOW ABOUT INVESTING IN CHINA

Not sure about investing in a Chinese company? Tencent might be a good way for you to start. Read more here!

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Let's Break It Down

It's tough to label Tencent. You could call it the largest gaming company in the world. Calling it a social media giant works as well. But each of Tencent's businesses is big enough to make a difference to its results, and we're excited about each of them, so let's break them down.

Scroll left/right to view wide tables

Segment	Quarterly Revenue	% of Business	YoY Growth
Online Games	$3.52 billion	42.2	39%
Social Networks	$1.91 billion	22.9	51%
Online Advertising	$1.50 billion	17.9	55%
Other	$1.43 billion	17.0	177%

- **Online Games**: It's true. Tencent is the largest gaming company in the world, with a massive collection of PC and mobile games. The entire video-game industry is growing as more people play more games more often, and Tencent is riding that wave. The company has also been acquiring (or heavily investing in) rivals including Riot Games (*League of Legends*), Glu Mobile, and Supercell. And it owns about 5% of **Activision Blizzard** (NASDAQ: ATVI). Going forward, we should expect Tencent to begin taking more of its own

KEY DATA

- **Headquarters:** Shenzhen, China
- **Website:** Tencent investor relations
- **Sign of a Breaker:** Top Dog
- **Market Cap:** $407.1 billion
- **Cash/Debt:** $19.9 billion / $17.6 billion

games international — including the smash hit *Honor of Kings*. Tencent is also in a prime position to dominate e-sports in China. In fact, it's even building an e-sports town.

- **Social Networks**: QQ has an impressive 850 million monthly active users (MAUs), but the real story is WeChat, with 963 million MAUs. WeChat was created to be Tencent's dominant mobile platform. It made social networking a feature, rather than the sole function, paving the way for new types of interactions (with businesses, celebrities, friends) with a built-in payments infrastructure. As such, most of WeChat's revenue isn't from ads, but rather from paid digital content services (live streaming, video, music, virtual items). WeChat perfected the app-within-an-app model; it holds its own internal app store and lets users conduct a variety of tasks in one place (hailing a car, ordering food, buying tickets, etc.). WeChat is practically a monopoly, and over one-third of all Chinese Internet time is spent on WeChat alone. The competitive advantages here are unreal.
- **Online Advertising**: Advertising may not by Tencent's top priority, but it isn't ignored either. Ads are placed within WeChat, but they're also placed among Tencent's other popular services, like Tencent Video and Tencent News. The company is attempting to be the leader across video, news, music, literature, and more; as popularity grows, ad dollars will follow. Advertising should also become more effective as Chinese per capita wealth expands.
- **Other**: This primarily includes Payments and Cloud. For years, **Alibaba**'s (NYSE: BABA) AliPay has dominated China's mobile-payments industry. However, in just three years, TenPay (or WeChat Pay) has grabbed more than one-third of the market. It's still smaller than AliPay, but it's growing fast, and most everyone uses WeChat. Cloud is also a fascinating business to watch. Tech companies around China are racing to grab market share in the cloud, and although the race is far from over, companies like Tencent are decently positioned to become truly competitive.

- **Revenue ('15/'16 / TTM):** $15.8 billion / $21.9 billion / $28.1 billion
- **Earnings ('15/'16 / TTM):** $4.4 billion / $5.9 billion / $7.9 billion
- **Recent Price:** $43.21

BUYER'S GUIDE

- **Industry:** Video Games, Social Media
- **Size:** Large Cap
- **Region:** China
- **Risk:** 6 out of 25 (see all our stocks here)
- **Crushability:** Carbon Steel (see the full scale here)
- **Most similar to:** Baidu, Facebook

Financial data from S&P Global Market Intelligence.

Data as of Sep. 25, 2017.

It's clear that Tencent is excelling in its existing businesses, and its overall competitive advantages are strong. And just as impressive as Tencent's growth is its profitability. Over one-third of revenue converts into free cash flow, and the company's negative cash conversion cycle points to a collection of wonderful business models.

Tencent uses its excess cash flow to pay a small dividend and invest in other companies. For example, it's investing alongside venture capitalists in ride-sharing companies Lyft and Didi Chuxing, as well as Indian e-commerce company Flipkart. However, it's also made larger investments. For example, it owns 18% of Chinese e-commerce site **JD.com** (NASDAQ: JD) and 5% of fellow Rule Breaker **Tesla** (NASDAQ: TSLA).

It's reasonable to predict that earnings could nearly double in the next couple of years, and triple within the next five. Non-GAAP net profit to shareholders grew 45% last quarter, and although that pace should slow, there's still plenty of room to rise. In reality, Tencent has what it takes to be one of the first trillion-dollar companies.

Risks and When We'd Sell

We'll start with the standard Chinese government crackdown risk. Tencent is cooperative, but if the government decides to more seriously alter what content it allows across Tencent's properties, the negative ripple effects could be significant.

In gaming, capital allocation is a risk. Tencent has spent serious money acquiring and investing in other publishers. If it overpays, then it's wasted billions of dollars. It's also unclear how well some of its proprietary games will perform in other countries, and heavy investments into e-sports may not pan out exactly as planned. Plus, Tencent has to impose a time limit on *Honor of Kings* with its younger gamers — probably good for their health, but it does limit sales.

With WeChat and QQ, there's always a risk of the next big thing stealing mindshare. QQ is slowly losing MAUs, and even though time spent on WeChat is a major strength, if we see that slip, then that's a yellow flag. Also, if the advertising growth rate decelerates substantially as well, we should begin to question just how successful that model will be in the long term.

Lastly, it's unclear what kind of returns investors should expect from Tencent's investments into other companies, but those moves make capital allocation an even larger threat to Tencent's value. If Tencent proves to be a poor venture investor, both the company and its shareholders will miss the cash.

The Foolish Bottom Line

The Internet allows low-inventory, capital-light businesses to scale to tremendous heights while generating enormous cash flows. Tencent is a prime example, and despite its large size, the company's runway remains vast. We expect its already dominant position to grow stronger and its sales and earnings to soar higher. Tencent's come a long way, but when you consider the opportunities still ahead of it, its market cap is nothing but a number.

Tencent 腾讯

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Aaron Bush owns shares of Activision Blizzard, Baidu, Facebook, and Tesla. David Gardner owns shares of Activision Blizzard, Baidu, Facebook, and Tesla. David Kretzmann owns shares of Activision Blizzard, Baidu, Facebook, and Tesla. Karl Thiel owns shares of Facebook. Tom Gardner owns shares of Baidu, Facebook, and Tesla. The Motley Fool owns shares of Activision Blizzard, Baidu, Facebook, JD.com, and Tesla. See the team's and David and Tom Gardner's holdings here. Fools may have an interest in the stocks mentioned.
