



Tencent 腾讯

WeChat about China's Tencent



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Chris Wheldon, co-Portfolio Manager of the Magellan High Conviction strategy, and Ryan Joyce, co-Head of Magellan's Technology team, explain why Tencent is a high-quality business, why the strategy invested in the company recently, what risks the investment poses and why Tencent performed well during the pandemic's initial stages.

Q1. Tencent is one of the High Conviction strategy's top five positions. Can you please tell us about the company?

A: Tencent was founded in 1998 as a Chinese instant-messaging service and web portal named QQ and subsequently built itself into a PC-based social network similar to today's Facebook. In 2011, Tencent launched the WeChat mobile app, now China's leading social network and communications platform and core to the company's success. WeChat's 1.2 billion users average nearly 100 minutes per day, every day, on the app.

In addition to generating significant advertising revenue from WeChat, in a similar manner to how Facebook monetises its app, over the past decade Tencent has successfully leveraged WeChat's user traffic to build leading positions in online gaming, digital payments and fintech, cloud computing and other areas including online video, music and news within China. Tencent, for example, has 112 million video subscribers in China compared with Netflix's 183 million subscribers globally.

Online gaming, which is wildly popular in China, was one of Tencent's earlier successes and a key source of profits that the company has reinvested internally to build out its suite of services. Tencent has also created significant value for shareholders by taking large positions in Chinese internet companies such as JD.com, Pinduoduo and Meituan Dianping and making them more successful by positioning them prominently within the WeChat ecosystem.

"WeChat's 1.2 billion users average nearly 100 minutes per day, every day, on the app."



Q2. Magellan invests in high-quality businesses with enduring characteristics.

What are Tencent's?

A: We think Tencent is a high-quality business. As mentioned, at the core of the company is its dominant WeChat social network and communications app that can be thought of as the portal through which Chinese citizens conduct their digital activities and access digital content. Critically, social networks by their nature tend to be advantaged and resilient businesses given that the more people use them, the more valuable they become. With 1.2 billion users, WeChat hosts nearly every Chinese citizen's social circle.

Shrewdly, by building WeChat into a super app that funnels users to owned and third-party services, Tencent has further entrenched itself into the digital lives of Chinese consumers. Tencent's apps now represent roughly 40% of total user time spent on mobile in China. Importantly, Tencent is expanding its suite of services; recent innovations include WeChat mini programs that have already exceeded 400 million daily active users and which position WeChat as more akin to an operating system.

While online gaming is a more 'hit' driven business, we consider Tencent's gaming business to be the largest and most advantaged globally and significantly more resilient than its peers given the benefits it gains from the integration with WeChat. This brings a significant distribution advantage and an unmatched ability to integrate social elements such as 'friend leader boards' and multi-player games. Tencent is also protected from western game developers that are reliant upon Chinese publishers to access the Chinese market.

Outside of social networks and online gaming, Tencent has the No. 1 or No. 2 positions in what we consider to be naturally oligopolistic industries such as digital payments, cloud computing, online music and online video where 'first mover' advantage, scale and the ability to invest upfront are critical. While competition within these industries can be fierce in their early stages, they offer significant long-term growth potential and we expect profitability to improve as the industries mature.

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腾讯游戏
Tencent Games

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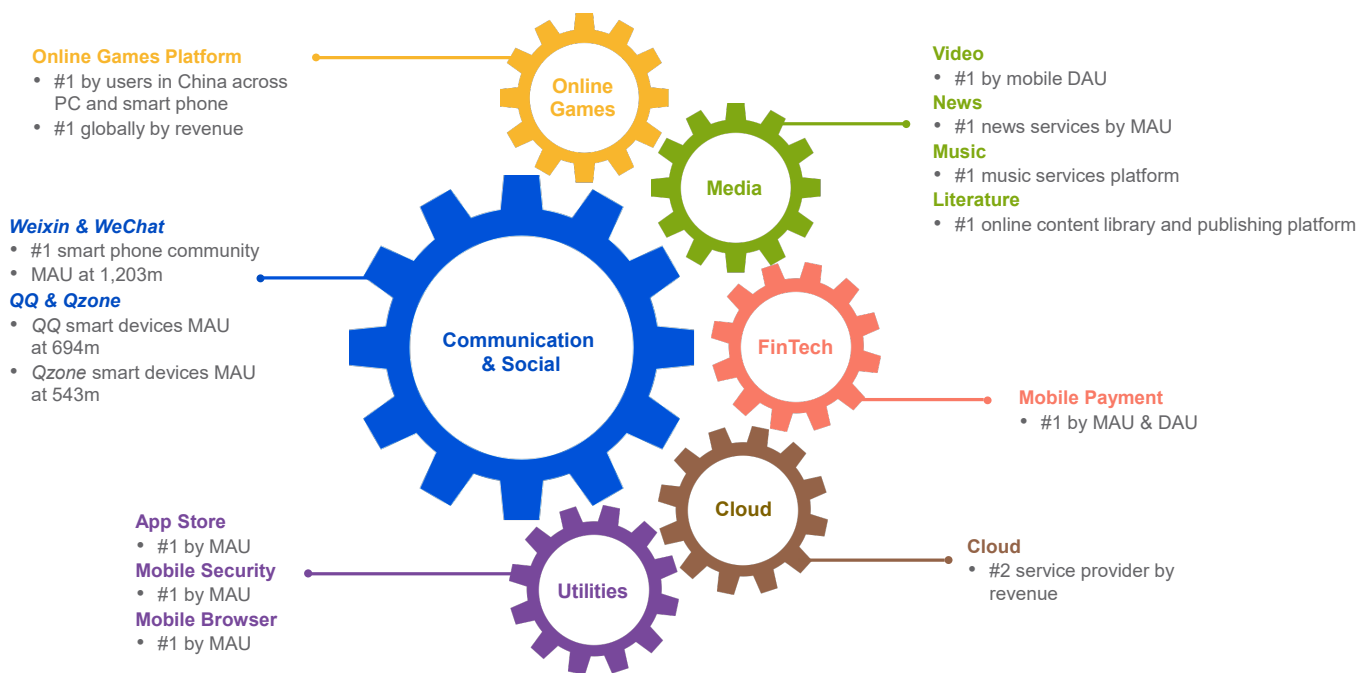
Q3. Can you outline why we have invested in the company only recently?

A: Two key reasons have influenced our decision to invest in Tencent recently. The first is our assessment of Tencent's fair value relative to its share price. While Magellan has a focus on investing in high-quality businesses, we seek to be patient and to acquire positions when they are trading at a discount to a conservative estimate of fair value. Even for wonderful businesses, we believe valuation discipline is critical to earning desired returns for our clients. When we began looking at Tencent closely in 2017, we thought there was too much optimism factored into its share price, likely reflecting the expected growth of its online gaming business. We waited for a more attractive entry point that presented itself only recently.

The second reason is Tencent's increasingly diversified and higher-quality earnings mix. If we go back several years, Tencent's valuation was heavily reliant on its online gaming business. While we consider this business to be advantaged, it retains a hit-based profile and we had a lower degree of

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conviction in Tencent’s ability to achieve hit after hit even with its distribution advantage. Fast forward to today and not only are we more confident in the durability of Tencent’s online gaming business, but the company’s earnings mix has shifted towards online advertising, digital payments and media subscriptions. Our confidence in Tencent’s ability to generate strong earnings from its rapidly growing cloud business in the future has also increased markedly as it has emerged as a clear No. 2 player in China.



* All rankings above refer to China market, unless otherwise stated. Company data as of March 31, 2020
* QQ smart devices MAU declined due to our continued efforts to proactively clean up accounts that engaged in spamming and bots activities

Source: Tencent Investor Kit - 1Q20ResultsPresentation

Q4. Can you talk about the risks of investing in China?

A: With Tencent, the risk of greatest concern is regulatory risk across online gaming, social networks and payments. While regulatory risk is not unique to China – we see it with some of our US technology investments too – we are of the view that it is higher than in most developed countries due to the limited visibility and legal recourse. An example of this was the Chinese government’s surprise decision in 2018 to halt new online game approvals for nine months due to concerns about content and addiction among minors. These restrictions had a meaningful drag on Tencent though it was only temporary as the business recovered once approvals restarted. This risk highlights the value of Tencent’s more diverse earnings stream going forward.

Risks associated with investing in China rather than Tencent per se include the potential for Chinese government insistence that companies invest in uneconomic areas, and the need for foreigners to invest via ‘variable interest entity’ structures due to foreign-ownership restrictions. We consider the probability of either of these risks having a significant impact on the value of Tencent as low given the Chinese government’s interest in attracting foreign investment and maintaining cordial global relationships. We also manage these risks via portfolio risk controls.

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Q5. Has the covid-19 crisis hampered Tencent?

A: We expect Tencent to perform well during the lockdown phase of the pandemic and derive long-term benefits from its impact. During the lockdown phase, the company's highly profitable online gaming business benefitted from a significant increase in user engagement. This has more than offset the temporary headwinds from its payments and cloud revenue. While much of the increase in time spent online is likely to prove temporary, some will be structural as Tencent has observed during prior virus outbreaks. This dynamic also provides defensiveness in the case of further outbreaks.

Benefits to Tencent from the pandemic that we expect to become more evident over time include opportunities related to the critical role it played in online healthcare and online education during the lockdown, accelerated merchant adoption of its mini programs for e-commerce, significant uptake of its enterprise collaboration tools WeChat Work and Tencent Meeting, and an acceleration in enterprise demand for cloud computing and digital upgrades. The critical role Tencent played in helping China manage the spread of covid-19, while also enabling workers to operate remotely and students to learn remotely during this period, is also likely to have improved the company's relationship with the government.

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