

Research on the Valuation to Tencent: A Case Study

Yixin Weng^{1,a,*}

¹College of Tourism and Service Management, Nankai University, Tianjin, China, 300000
a. 2012386@mail.nankai.edu.cn

*corresponding author

Abstract: In the 21st century, people's life has been inseparable from the network, the network penetration rate of our life is unprecedented. Large Internet companies provide many job opportunities for the society, and more and more people flock to this industry for investment or entrepreneurship. Moreover, unicorns are more likely to emerge in Internet companies than in other industries. At the same time, financial leverage is more commonly used to obtain financial returns. It is necessary to study the financial situation of Internet companies. Tencent is a strong Internet company. However, according to its financial statements, it could be found that some hidden dangers, such as the rapid growth of liabilities, the decrease of asset turnover rate and asset turnover rate, led to the high financial leverage of Tencent. Although this strategy could produce high income effect and improved the efficiency of the enterprise's use of funds, it is a double-edged sword and increases the business risk of the enterprise. Based on the analysis of Tencent's debt paying ability, operation ability and profitability, this paper drew the conclusion that Tencent has operational risks due to its high financial leverage. Research data mainly came from Tencent's annual report.

Keywords: debt paying ability, operational capacity, profitability, financial leverage, financial risks

1. Introduction

Jensen believed that although a company's debt operation could relieve the pressure of capital demand to a certain extent, give full play to its resources and have more development opportunities to enhance corporate value, continued excessive debt operation would increase the company's financial risks and affect its sustainable health [1]. Henry found that there was a positive proportional relationship between earnings per share of common stock and financial leverage. If the industrial market environment had a good development prospect and the debt interest rate was fixed, the use of financial leverage would drive the increase of earnings per share of common stock. Therefore, appropriate debt management can bring profits to the company and promote the healthy development of the company [2]. Graham&Patrick believes that short-term debt will affect the profitability of the enterprise, but long-term debt will not. There is a reverse change relationship between short-term debt and profitability [3]. Alexander&Ilya argued that the level of financial leverage is affected by the size of the company, and there is a positive change relationship between the level of financial leverage and the size of the company. The higher the level of financial leverage, the larger the size of the company to some extent [4].

In the context of global de-leveraging, as a company with strong profitability, there are hidden dangers in Tencent. Suggestions are put forward to overcome these problems.

From 2020 to 2023, many enterprises' domestic business may encounter special opportunities or challenges because of Covid-19. Ma Huateng, Chairman of the Board of Directors of Tencent, mentioned in the 2020 annual report that "2020 is full of unprecedented challenges". Therefore, it is reasonable to believe that the data of these three years are not universal, so the focal point will be concentrated on data from 2015 to 2019 in this report.

Financial leverage is an analytical tool for enterprise financial management, and it is also an important means for enterprise managers to evaluate financing decisions accordingly. The effective grasp of the "degree" of financial leverage is conducive to the optimization of financial leverage effect. However, if the financial leverage is not well used, it will not only fail to bring the expected financial benefits to the enterprise, but also increase the financial risks faced by the enterprise, and even the risk of breaking the capital chain due to overdue debts. This paper analyzes Tencent's financial leverage and financial risk, which is conducive to Tencent's risk management while reducing the possibility of financial risk and the loss caused by financial risk. At present, Tencent, as a strong Internet company in China, has a certain influence on the development trend of the Internet industry in China. The analysis of the company's financial leverage effect and financial risk is of representative significance in the context of high leverage ratio and deleveraging in the industry.

2. About Tencent

2.1. Company Profile

Tencent's guiding principle is to use technology for good, and the company was founded in 1998. More than one billion people worldwide use their social and communication services to stay in touch with friends and family, get around, pay for their daily necessities, and even have fun.

In addition, Tencent produces some of the most well-liked video games in the world as well as other high-quality digital content, enhancing the interactive entertainment experiences of people all over the world. Tencent likewise offers a scope of administrations, for example, distributed computing, promoting, FinTech, and other undertaking administrations to help our clients' computerized change and business development.

Tencent has been recorded on the Stock Trade of Hong Kong starting around 2004 [5].

2.2. Main Business

Over the years, the largest source of revenue for Tencent has been value-added services (Tencent's main business can be divided into three categories, namely value-added services, online advertising and other businesses). Among them, Tencent's value-added services are divided into online game business and social network business. In the financial annual report published by Tencent in 2019, the total revenue of Tencent was 312.7 billion yuan, of which the value-added revenue reached 199.991 billion yuan, accounting for 53%.

Table 1: Forth Tencent's revenues by line of business for the years ended 31 December 2019 and 2018.

	2019		2018	
	Amount	% of total revenues	Amount (Restated)(RMB in millions, unless specified)	% of total revenues (Restated)
VAS	199,991	53%	176,646	56%

Table 1: (continued).

FinTech and Business Services	101,355	27%	73,138	23%
Online Advertising	68,377	18%	58,079	19%
Others	7,566	2%	4,831	2%
Total Revenus	377,289	100%	312,694	100%

3. Financial Valuation of Tencent

3.1. Debt Growth Rate

From the listing of Tencent in 2004 to 2019, the asset scale of Tencent has gradually increased in 16 years. The total assets of Tencent in 2019 (953.986 billion yuan) increased by 333.17 times compared with that of 2004 (2.863 billion yuan), among which the total liabilities increased particularly rapidly, and the liabilities increased by 2203.69 times in 16 years. Clearly, Tencent has grown rapidly in those 16 years.

3.2. Liquidity

3.2.1. Short-Term Liquidity

Table 2: Condensed consolidated statements of financial position [6].

	2015 (RMB'Million)	2016 (RMB'Million)	2017 (RMB'Million)	2018 (RMB'Million)	2019 (RMB'Million)
Non-current assets	151,440	246,745	376,226	506,441	700,018
Current assets	155,378	149,154	178,446	217,080	253,968
Total assets	306,818	395,899	554,672	723,521	953,986
Non-current liabilities	60,312	108,455	125,839	164,879	225,006
Current liabilities	124,406	101,197	151,740	202,435	240,156
Total liabilities	184,718	209,652	277,579	367,314	465,162
Total equity and liabilities	306,818	395,899	554,672	723,521	935,986

Table 3: Main Indicators of Tencent Holdings' Solvency from 2015 to 2019.

	2015	2016	2017	2018	2019
Current ratio	1.25	1.47	1.18	1.07	1.06
Quick ratio	1.25	1.47	1.17	1.07	1.05
debt to asset ratio	60.88%	52.96%	50.04%	50.77%	48.76%
EM	2.51	2.27	2.17	2.24	2.21

As can be seen from the chart, the trend of liquidity in the past five years is gradually weakening. From 2015 to 2019, the growth of current liabilities greatly exceeded the growth of current assets, leading to the reduction of the current ratio. A current ratio of 2 and a quick ratio of 1 are generally considered appropriate. It can be seen that the quick ratio of Tencent Holdings has been higher than 1 in the past five years, and the current ratio has decreased from 1.47 in 2016 to 1.06 in 2019. Overall speaking, Tencent's current ratio is low, so the short-term liquidity of the enterprise needs to be further improved. However, based on the quick ratio reaching 1 and rising, the short-term liquidity of Tencent Holdings is still within a reasonable range.

3.2.2. Long-Term Liquidity

In 2004, Tencent's asset-liability ratio was 7.37%. In the following 16 years, Tencent's asset-liability ratio steadily increased. By 2019, it had increased to 48.76 percent. This shows that Tencent has created more profits by leveraging its ability during the period, resulting in a gradual increase in the company's debt risk. Later, due to the increase of accounts payable, other accounts receivable, withholding fees, long-term payables and other amounts, the growth of liabilities was significantly greater than that of assets. In 2015, the asset-liability ratio reached a peak of 60.88%. This also indicates that Tencent has had high financial risks in recent years. There was a weak downward trend from 2016 to 2019. The decrease in the asset-liability ratio is mainly due to the expansion of accounts payable and notes due to the expansion of business scale in recent years. The asset-liability ratio fluctuated between 40% and 60%, which was within a reasonable range. Tencent's equity multiplier averaged above 2 from 2015 to 2019. Overall, Tencent leads the industry in its ability to repay debt.

3.2.3. Operational Capacity

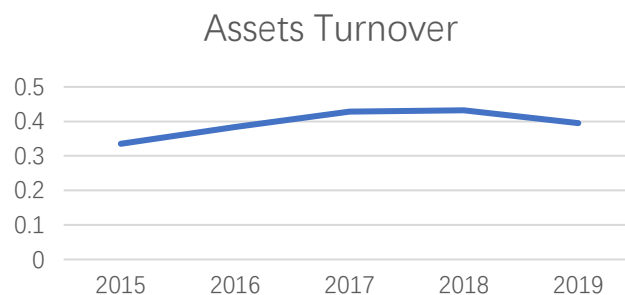


Figure 1: Tencent's Assets Turnover from 2015 to 2019.

Tencent's total asset turnover also showed a downward trend from 2016 to 2019, indicating that in recent years, the enterprise's asset utilization efficiency has become low and its sales ability has become weak, so it needs to improve its asset management level. It is worth mentioning that Tencent Holdings, as an Internet enterprise, keeps the accounts receivable, fixed assets and inventory below 4%, 6% and 1% respectively. It is an asset-light enterprise with low cost of competitiveness. Overall, Tencent operating capacity is good.

3.2.4. Profitability

Profitability refers to the ability to obtain profits, which is generally reflected in the amount and level of an enterprise's income in a certain period of time. Based on the analysis of the income statement presented in the annual report of Tencent from 2015 to 2019, all the indicators in the income statement of Tencent from 2004 to 2019 showed a trend of rapid rise. Before 2013, the total profit of Tencent was always higher than the operating profit. Since 2014, the non-operating expenditure of Tencent has been greater than the non-operating income, which is also caused by the large profit and loss of other non-operating items of Tencent in recent years. In general, the total profit of Tencent accounts for about 40.29% of the operating income, among which the operating profit is the main source of the total profit, while the profit and loss of other non-operating items take a small proportion and have little impact on the total profit. This also shows that Tencent is a business activities-oriented enterprise. From the three indicators of operating gross profit rate, operating net profit rate and return on equity, Tencent's operating gross profit rate is twice as high as the industry average, reaching 65%, which proves the company's strong profitability. At 38%, the operating margin is more than double the industry average. It declined over the next few years, but was still about twice the level of the industry tie.

4. Suggestion

Undeniably, Tencent's business model is worth learning from. There are also some hidden dangers. First of all, the "explosive" expansion of Tencent's balance sheet has made its financial leverage increasingly high. Although it has been controlled, high financial leverage is still a double-edged sword for the Internet industry. If external financing is needed, Tencent's financial risks will be gradually expanded. This means that the Tencent company needs to strengthen the consideration of attention. Secondly, as Tencent has gained a foothold in the domestic original game market, there are still many shortcomings in the aspect of originality. Tencent should not be blinded by the increasing operating revenue year by year, so it needs to strengthen technological innovation and development.

By reasonable control of financial leverage brought by the risk, it is suggested to enhance solvency. Although it is necessary to support diversified development through debt to a certain extent, enterprise management should attach importance to debt risks, optimize its capital structure, formulate reasonable debt strategies, pay attention to the company's solvency and cash flow changes, and avoid the break of capital chain.

Innovation is the core element of an enterprise to maintain vitality and competitiveness. With the rapid development of the internet industry, in order to gain market share in the fierce market competition environment, in addition to maintaining the stability of basic business, it is also necessary to increase investment in product innovation and expand the product market. Business models need to be constantly innovated, and profit models tailored to local conditions should be formulated according to factors such as the enterprise itself and social environment, so as to develop and move forward in the fierce market competition [7]. Tencent, as a typical platform enterprise, should improve product content and innovate product business channels.

5. Conclusion

Tencent has been in the industrial investment stage since 2015. In this stage, Tencent's investment goal is to continuously expand ecological capacity through corporate venture capital investment, take root in consumer Internet and embrace industrial Internet. Tencent venture capital investment can indeed create financial value and strategic value for enterprises. In terms of financial value, Tencent makes effective use of cash assets through venture capital investment, which not only brings considerable investment returns, but also helps enterprises to better create financial value by improving their profitability and growth ability. In terms of strategic value, corporate venture capital investment helps enterprises attract high-level talents, improve core competitiveness, create option investment with growth value, reduce the uncertainty faced by enterprises by improving the internal management ability and customer ability of enterprises, and create strategic value for enterprises. The short-term performance of Tencent's venture capital investment is related to its venture capital investment mode and investment scale. Diversified investment in multiple industries and excessive investment in large quantities will lead to the reduction of short-term performance of the company's venture capital investment. Tencent's venture capital activities have a certain inhibitory effect on the enterprise's internal learning and innovation ability. Tencent's large amount of corporate venture capital activities led to the decline of its research expense rate, which had a negative impact on its internal innovation performance.

The analysis in this paper is mainly based on various indicators and financial annual reports, which ground on the summary and integration of data. These are the reasons for the formation of risks have not been deeply analyzed, and the correlation between various phenomena has not been observed and explained. Literature collection is also mainly focused on the analysis of Tencent, and there is no systematic and extensive collection of literature from the perspective of the whole Internet company. In the following research, the scope of literature research will be expanded, the internal relationship between various indicators will be sought, a scientific and reasonable research model will be built, and the reasons for the formation of phenomena will be explored at a deeper level.

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