SABER | SABER CAPITAL MANAGEMENT, LLC

Tencent's Wide Moat

Manual of Ideas
Wide Moat Investing Summit
2017

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Saber Capital's Investment Approach

Saber's strategy: Selective investments in high-quality businesses at attractive prices

- But, who isn't trying to do that?
- Simple, but not easy.
- So how do we execute this approach successfully?

How to Produce Great Long-term Results?

Focus on reducing unforced errors.

- Reducing losses is critical to great long-term results.
- Best way to reduce losses is to reduce “unforced errors” (mistakes that could be prevented).
- How do we reduce unforced errors?

How To Reduce Unforced Errors?

Focus on investing in companies that are very likely to be **earning more money in the future** than they are today.

- Simple, not easy: Cheap stocks of poor businesses are a value investor magnet.
- Amateur tennis: "just focus on hitting it over the net"
- Better solution: stick with predictable earning power
- Mr. Market is moody: even stocks of the best companies are volatile

Price Moves More Than Values

Top 10 Largest Companies in S&P 500 (as of 6/24/2016)						
Company	**Ticker**	**Current Market Cap ($ billions)**	**52 Week Low**	**52 Week High**	**% Change (High/Low)**	**$ Change in Market Value ($ billions)**
Apple	AAPL	$511	89	133	49.4%	$239
Google	GOOG	$459	515	790	53.4%	$187
Microsoft	MSFT	$391	40	57	42.5%	$134
Exxon Mobil	XOM	$370	67	92	37.3%	$106
Amazon	AMZN	$330	426	731	71.6%	$145
Berkshire Hathaway	BRK-B	$326	124	148	19.4%	$60
Facebook	FB	$320	72	121	68.1%	$141
Johnson & Johnson	JNJ	$318	82	118	43.9%	$100
General Electric	GE	$274	19	32	68.4%	$117
AT&T	T	$255	31	42	35.5%	$69
	Average % Change High/Low				**48.9%**	
	Average $ Change in Market Value				**$130 billion**	

Common Sense Approach to Investing

"Your goal as an investor should simply be to purchase, at a rational price, a ***part interest in an easily-understandable business whose earnings are virtually certain to be materially higher five, ten and twenty years from now****. Over time, you will find only a few companies that meet these standards -- so when you see one that qualifies, you should buy a meaningful amount of stock…*

"…Put together a portfolio of companies whose aggregate earnings march upward over the years, and so also will the portfolio's market value."

- **Warren Buffett,** 1996 Shareholder Letter

How to Estimate Future Earning Power?

Understand the company's competitive advantage and estimate the durability of that advantage.

An Overview of Traditional Moats

- **Barriers to Entry** (Waste Management, Exxon Mobile)
- **Network Effects** (Facebook, CoStar, Priceline)
- **High Switching Costs** (SAP, IBM)
- **Brand Power** (Coke, Apple, Nike)
- **Distribution** (Wal-Mart, Kraft, Gillette)
- **Economies of Scale** (Amazon, Costco)
- **Low-cost Producer** (Bank of America, GEICO)

But Some Moats Are Eroding in Value

"Each day, you're either getting better, or you're getting worse."

– Bo Schembechler, former Michigan football coach

- Not all moats are created equal.
- Some of those competitive advantages are gaining strength, while others are seeing their importance eroding.
- For example, let's look at distribution…

Distribution – This Time is Different

Distribution advantages have deteriorated for big, profitable incumbent companies:

- Costs of distribution have declined
- Companies can sell directly to the consumer much easier
- Products can scale faster
- Social Media has leveled the playing field for smaller companies with no advertising budget
- Consumers have many more choices now

Distribution – Gillette vs. Dollar Shave Club

- Gillette can no longer rest on the distribution advantages

- Gillette had shelf space, which gave it ability to charge high markups, which allowed for sizable advertising spend, which gave it greater scale, which further entrenched its incumbent position, making it difficult for competitors to attack

- But that advantage has been eroded thanks to technology (internet, social media)

- Dollar Shave Club and Harry's can now bypass the middleman and sell directly to the consumer, avoiding the retail markup and thus providing better value to the customer

Moats – This Time is Different

So some moats are deteriorating. Distribution advantages have been mitigated due to the fast pace of change:

- Cable networks like ESPN or Discovery relied on the “bundle”
- Consumer brands used to have shelf space and consumer confidence, which allowed for sizable profit margins
- Now customers have more choices and better information on products, so no need to go with “trusted brand”
- Even some authors are choosing to “self-publish” on Amazon or elsewhere, bypassing the publisher and going “direct to consumer”

Key Checklist Question

- Is this company really providing an attractive value proposition for the end-customer?

Most Important Moat

- Management focused on long-term value
- Management that is willing to adapt to fast changing or adverse conditions
- A business that is providing the best value to customers
- I believe that a combination of these three factors leads to the most durable competitive advantage in today's business world.

The Opportunity Bezos Capitalized On

"The balance of power is shifting toward consumers and away from companies. The right way to respond to this if you are a company is to put the vast majority of your energy, attention and dollars into building a great product or service and put a smaller amount into shouting about it, marketing it."

- Jeff Bezos

Tencent – A Huge Moat in China

Tencent Holdings (HK: 700; OTC: TCEHY)

Buffett's "Inevitables"

- Companies that Buffett felt were sure to do well over time due to structural competitive advantages
- But some of these structural advantages have been eroded, due to unforeseen technology
- Today's inevitables are not the companies that are resistant to change (because change impacts all now)
- Today's inevitables understand change and can adapt, while always focused on customer value
- Google, Amazon, & Facebook exhibit these qualities
- There are also numerous "inevitable" companies today in China…

Note: "inevitable" doesn't mean the stock is necessarily cheap, just that the business will likely continue to do well.

The Inevitable Trend in China

- These companies benefited from the “walled-garden” internet in China…
- But, more significantly, they’ve benefited from a rising middle class that is using the internet more, and spending more online
- This is a trend that in my view is an “inevitable”.
- Internet usage will certainly grow, and thus online ads, ecommerce, and mobile payments will follow suit
- Unlike the airlines in the 1950’s, this “inevitable” industry will create massive profits for its winners
- One of these inevitable companies that will capitalize on this inevitable trend is Tencent

What Does Tencent Do?

Tencent is an internet holding company that has the following main businesses:

1. **Digital Advertising** – 938 million highly-engaged users on WeChat, the "Super-app"

2. **Video Game Publishing** – High margin, high ROIC business that throws off significant free cash flow

3. **Mobile Payments** – WeChat Pay is one of the largest mobile payment platforms in China

4. **Media Subscriptions** – Over 100 million people subscribe to Tencent's news platforms, music, movies, video, and original content *(think Apple Music, Youtube, and Netflix combined)*

5. **Ecommerce** – Tencent is a partner & minority owner of JD.com; WeChat is a potential ecommerce hub

What If One Company Did All Of This?

facebook
WhatsApp
YouTube
MasterCard
VISA
NETFLIX
MUSIC
Nintendo®
EA SPORTS
PayPal

Highly Profitable & Growing Fast

Tencent Holdings Income Statement Snapshot								
($ in millions; 1 USD = 6.81 RMB)	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**5-yr CAGR**	**Yr-on-Yr**
Revenues	$ 4,183	$ 6,444	$ 8,872	$ 11,587	$ 15,100	$ 22,304	39.8%	47.7%
Pretax Profit	$ 1,776	$ 2,209	$ 2,830	$ 4,259	$ 5,317	$ 7,581	33.7%	42.6%
Pretax Margin	42.5%	34.3%	31.9%	36.8%	35.2%	34.0%		
Net Profit	$ 1,498	$ 1,869	$ 2,276	$ 3,495	$ 4,229	$ 6,033	32.1%	42.7%
Capital Employed	$ 1,633	$ 1,683	$ 2,829	$ 8,368	$ 13,742	$ 19,111		
ROIC	108.7%	131.3%	100.0%	50.9%	38.7%	39.7%		

(source: Tencent presentation)

Why Tencent is a Great Business to Own

1. **WeChat's Network** – Used by everyone in China; chat, payments, work groups, social, shopping, money transfers, hailing cabs, paying bills, and much more

2. **Massive Runway** – Tencent is a leader but still has a very small slice of large, growing markets such as mobile advertising, ecommerce, payments, media content, cloud and games

3. **Great Businesses** – High margins, free cash flow, recurring revenue streams, low capex

4. **Founder/Operator** – Focused on Creating Maximum Long-term Value

Advantage #1: WeChat

What is WeChat?

"Like most professionals on the mainland, her mother uses WeChat rather than e-mail to conduct much of her business. The app ***offers everything*** *from free video calls and instant group chats to news updates and easy sharing of large multimedia files…*

"Yu Hui's father uses the app to ***shop online, to pay for goods at physical stores, settle utility bills and split dinner tabs*** *with friends, just with a few taps. He can easily book and* ***pay for taxis, dumpling deliveries, theatre tickets, hospital appointments*** *and foreign holidays,* ***all without ever leaving the WeChat universe.****"*

- Economist article "WeChat's World" *(emhasis mine)*

WeChat: The Everything App

"As one American venture capitalist puts it, WeChat is there ***"at every point of your daily contact with the world, from morning until night.****"*

- Messaging (no more texts or emails)
- Social Networking
- Work Groups (Slack alternative)
- Online Shopping and Mobile Payments
- Payments at Physical Stores
- Much more…. paying bills, hailing cabs, ordering food, sending money to friends, event tickets, etc...
- **All without ever having to leave the WeChat app**

A Classic Network Effect

- Network effect results when each incremental new user increases the value for everyone else
- WeChat attracts users because of its extremely high-value user experience
- Which attracts more users who want to interact with each other
- Which attracts developers, merchants, and advertisers that want to sell something to these users
- Which further attracts more users, etc...

WeChat's Massive Network

- 938 million users and still growing (up 23% yoy)
- 12 million official accounts (think Facebook business pages)
- User engagement is rapidly growing
- *Average* user spends 66 minutes a day on WeChat (more than Facebook and Instagram combined)…
- But a third of WeChat's users spend a whopping **4 hours a day or more** on the app!

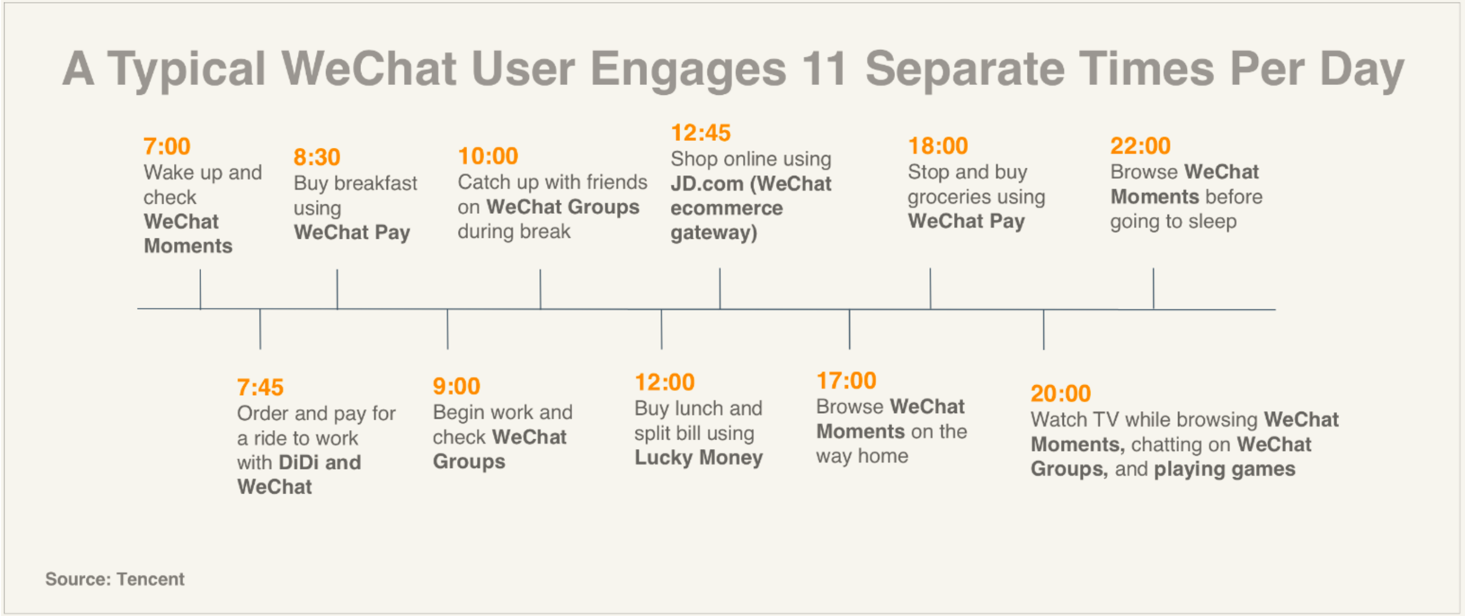
Sources: Quote from Economist "WeChat's World";
Data: comScore, Penguin Research, Facebook, Tencent filings

WeChat Payments

- Convenience – one payment system for all apps inside WeChat (vs. re-entering card info into each app)
- Used for both online and offline payments
- Cheap for merchants
- This fuels more user adoption
- WeChat Pay has 40% market share in China
- 600 million daily transactions on WeChat
- An estimated $1.2 trillion passed through WeChat Pay's network in 2016
- B2C WeChat Payments transactions (both online & offline) up 200% yoy

Sources: Tencent Conference Calls, Tencent Filings,
Better Than Cash Alliance China Report 2017

A Typical Day on WeChat



(Source: Ycombinator, Tencent)

“I Haven’t Gotten a Text in like 2 Years”

“Did you get my text? I was checking if your number is the same.”

“Oh yeah, I did,” she says. “I didn’t answer ***because I haven’t gotten a text in like two years****.”*

- A Chinese person to a foreign, visiting friend *(source: Fast Company)*

- WeChat has largely replaced texting and email in China.
- Social: We use texts, emails, or phone calls. They use WeChat for all of those.
- Work: We use Slack for work groups and email for reaching co-workers. They use WeChat.

WeChat Summary

- WeChat is akin to the “operating system” of China
- It touches everything in China
- Great value for users…
- Who are spending more and more time on the app…
- Which attracts businesses and advertisers…
- Who will do more and more business on the app…
- Which results in an incredibly valuable asset for Tencent

Advtantage #2 – Long Runway

1. Mobile Advertising
2. Digital Content (Video, Music, Movies)
3. Ecommerce
4. Payments
5. Video Games
6. Cloud

These are very large and fast-growing markets that Tencent is well-positioned for, but has barely scratched the surface in terms of monetization.

Advertising – WeChat vs. Facebook

($ in billions)	**2010**	**2016**
Facebook Ad Revenue	$2.0	$27.6
	2016	**6 Years Later**
WeChat Ad Revenue	$2.3	?
China Online Ad Market	$50	?

- It took Facebook **6 years to go from $2 billion to $27 billion** (and $10 billion in profits)
- WeChat has more users now (who spend more time on the platform) than Facebook had in 2010
- WeChat has a small slice of China's online ad market that is growing currently at 25% annually

Sources: Company filings, online ad market is eMarketer's estimate, my calculations based on segment data from company filings

Advertising – WeChat's Untapped Ad Capacity

Facebook shows over **25 times more ads** than WeChat:

China Channel

ESTIMATED NUMBER OF NEWSFEED AD IMPRESSIONS PER DAY

PLATFORM	Q1 2016	Q2 2016	Q3 2016
WECHAT MOMENTS	0.2	0.3	0.4
FACEBOOK GLOBAL	8.8	9.3	10.6
FACEBOOK US & CANADA	20.6	23.2	25.6
FACEBOOK ASIA	9.0	9.2	12.4

Data Source: Daiwai Capital Markets

CHINACHANNEL.CO

Untapped Pricing Power – Revenue per User

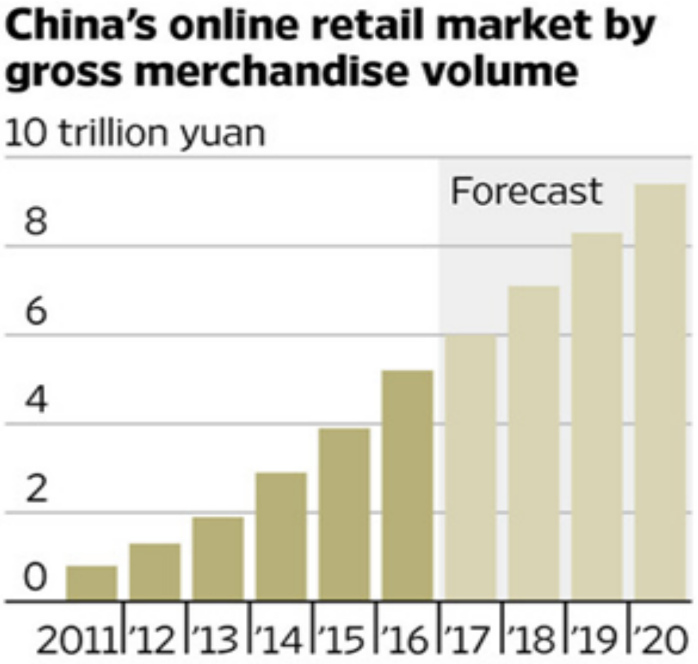
Facebook vs WeChat Currently		
	Facebook	**WeChat**
User Minutes Spent per Day 2016	50	66
Average Revenue per User 2016	$15.98	$3.49

- WeChat is more essential to life in China than Facebook is here
- I believe WeChat has enormous untapped pricing power

Sources: Company filings, conference call transcripts,
my calculations based on segment data from company filings

Ecommerce – A Trillion-Dollar Market

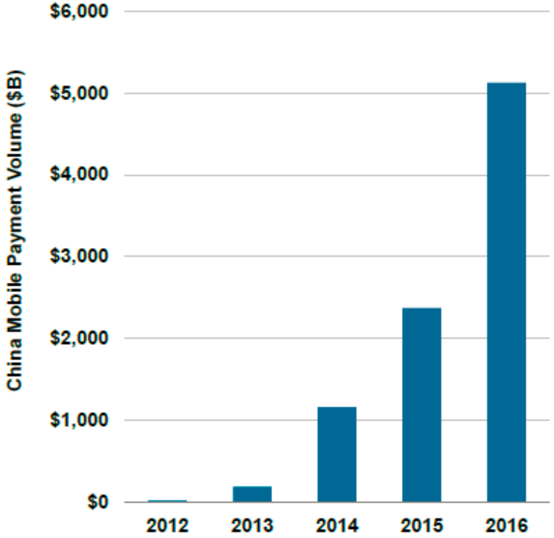
- Imagine a business that does **$1 trillion** in revenue…
- That is growing at 20% per year…
- That is China's ecommerce market
- But Tencent hasn't yet monetized this potential
- Tencent owns stake in JD, which did $38b rev last year (still a small slice of the growing pie)
- Luxury brands like Burberry and Dior just started selling on WeChat's platform in 2017
- WeChat is well-positioned to eventually extract a toll on this industry



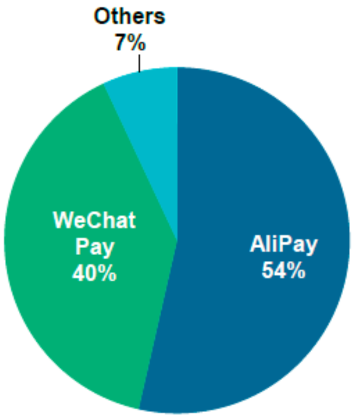
Note: 10 trillion yuan = $1.5 trillion (June 2017)
Sources: Bain & Co., Wall Street Journal, JD.com filings

Exploding Growth in Mobile Payments

China Mobile Payment Volume, 2012 - 2016



China Mobile Payment Market Share*, Q1:17



KLEINER PERKINS

Source: Analysys
*Excludes certain P2P and transfer payments. Assume constant FX rate of 1USD = 6.9RMB.

Hillhouse Capital

Advantage #3 – Free Cash Flow

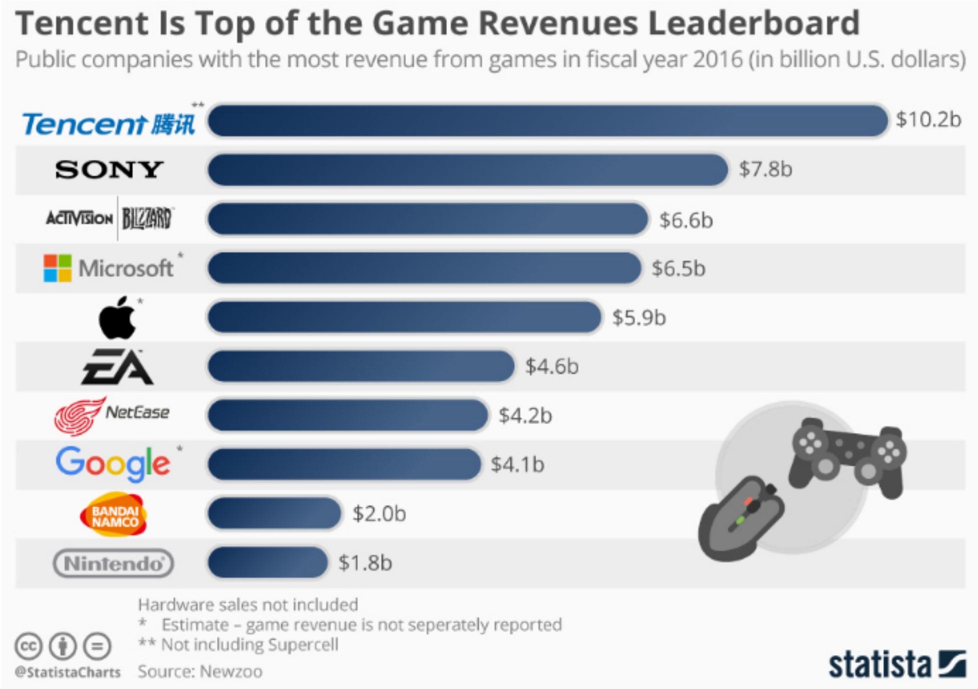
- Tencent will produce around $8 billion of free cash flow in 2017
- This stream of cash is growing fast
- Tencent's main businesses like mobile advertising and game publishing are very high return on capital businesses with huge profit margins
- The predictable gaming free cash flow is the fuel that gives Tencent an edge to invest in areas such as original content, music, cloud, and more

Video Games

- About half of Tencent’s revenue comes from its gaming business
- Video games are a great business (high returns on capital, huge margins and free cash flow)
- Tencent publishes the most widely recognized games in the world such as League of Legends, Clash of Clans and Honor of Kings
- Strategy was to buy developers like Supercell and Riot Games and give them total autonomy
- Recently Tencent has begun developing its own games, with huge success (Honor of Kings is the most popular mobile game in the world)
- Games are very popular in China, with 417 million online “gamers”

Source: Tencent filings, CNNIC Statistical Survey on Internet Development in China

World's Largest Video Game Publisher



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Free Cash Flow Feeds Media Content

- FCF from the gaming business gives Tencent deep pockets to invest in content
- Netflix had $1.7 billion in negative operating cash flow last year
- Netflix's long-term debt has gone from just $200m in 2012 to $3.7 billion in 2016
- Content is expensive
- But very valuable if you can reach scale (huge operating leverage)
- Tencent can outbid smaller rivals because of its enormous free cash flow
- Plan is working: 20m video subs (+200% yoy), developing popular original content, Hollywood partnerships (Wonder Woman), Universal Music partnership, etc…
- Tencent has 119 million subscribers across all of its digital media platforms

Advantage #4 – Great Management

"Wealth won't give you satisfaction. Creating a good product that's well received by users is what matters most."

– Pony Ma, in 2011, shortly before WeChat was launched

- Ma started Tencent in 1998
- Owns just under 10% of Tencent
- Is intensely focused on user experience
- Is very focused on the long-term

Importance of Embracing Change

- Bezos said in his recent letter to embrace big trends, not to fight them (or deny they exist)
- Example: Amazon developing the kindle for digital books at the expense of its hard copy book business
- Tencent had a product called QQ, which was a desktop messaging platform that was also massively popular in China, and still has over 800 million users
- Pony Ma recognized the shift to mobile, staffed two teams (one from QQ and one "outside" team) to solve the issue.
- The QQ team came up with a product that was very similar to QQ desktop, but the outsider team invented WeChat
- Many lessons from this competitive experiment, including the power of "endowment bias" and the difficulty of thinking outside the box (but the importance to being able to do that as a leader)

Valuation: Tencent's Financial Snapshot

Tencent Holdings Income Statement Snapshot								
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Capital Employed	$ 1,633	$ 1,683	$ 2,829	$ 8,368	$ 13,742	$ 19,111		
ROIC	108.7%	131.3%	100.0%	50.9%	38.7%	39.7%		

ROIC = Pretax Profit / Capital Employed
Capital Employed = Net working capital + PP&E + Investments in Associates + AFS Securities – Excess Cash

Valuation

- Tencent will earn around $8.5 billion in 2017 (my estimate of owner earnings)
- Market Cap = $332 billion (as of 6/16/17)
- TCEHY share price = $34.98 (as of 6/16/17)
- 39 P/E is a bargain?

Valuation – P/E’s Don’t Live in a Vacuum

- 39 P/E looks expensive, but…
- P/E’s don’t exist in a vacuum
- When looking at large groups of stocks, low valuation multiples will lead to better results on average (i.e. a diversified basket of low P/E stocks will do better than a diversified basket of high P/E stocks)
- But individually, companies have widely varying fundamentals and thus are worth widely varying prices relative to earning power
- In other words, sometimes a 40 P/E stock is cheap and sometimes a 10 P/E stock is overvalued
- Past examples: Starbucks was very undervalued at 50 P/E; Kodak would have been overpriced at 5 P/E

Valuation: The Importance of ROIC

"If the business earns 6% on capital over 40 years and you hold it for that 40 years, you're not going to make much different than a 6% return—even if you originally buy it at a huge discount. Conversely, if a business earns 18% on capital over 20 or 30 years, even if you pay an expensive looking price, you'll end up with a fine result."

- Charlie Munger

ROIC: Greater Impact on Value than P/E

	Reinvestment Corp.	Undervalued Corp.
Current Earnings Power	$100	$100
Beginning Multiple	20x	10x
Current Valuation	**$2,000**	**$1,000**
% of Earning Reinvested	100%	50%
Returns on Retained Earnings	**25%**	**10%**
Cumulative Dividends*	$0	$629
Year 10 Earnings Power	$931	$163
Year 10 Multiple	15x	15x
Year 10 Valuation	**$13,970**	**$2,443**
Total IRR**	**21.5%**	**13.6%**
Multiple on Original Investment	7.0x	3.0x

**Assumes all earnings not reinvested are distributed as dividends*

***Pre-tax IRR, factoring in tax rates will only further the advantage of Reinvestment Corp.*

Source: Connor Leonard
http://basehitinvesting.com/importance-of-roic-reinvestment-vs-legacy-moats/

Determining Intrinsic Value Compounding

- The value of a business does not come from what it earned last year
- The value of a business comes from the discounted value of the cash flow that the business will earn in the future
- A better way to think about value: estimate the annual growth rate of a company's intrinsic value
- This can be estimated by determining how much cash flow a business is generating, what percentage of that cash flow can be retained and reinvested back into the business, and what rate of return that incremental investment earns
- In other words, a business will compound its intrinsic value by approximately the product of its ROIC and its reinvestment rate (capital allocation for the portion of earnings that can't be reinvested also impacts the company's intrinsic value)
- **Intrinsic Value Growth = ROIC x Reinvestment Rate**

Tencent's Incremental ROIC

Tencent's Incremental Returns on Capital		
	2011	2016
Capital Employed	$ 1,633	$ 19,111
Pretax Earnings	$ 1,776	$ 7,581
Incremental Capital Employed	$ 17,478	
Incremental Earnings	$ 5,805	
Incremental ROIC	**33.2%**	

Tencent’s Intrinsic Value Compounding Rate

- **Incredible Profitability**: Tencent is producing 39% pretax returns on capital with 34% operating margins
- **Growth**: Revenue and earnings are growing at 40%+
- **Runway**: The company still has large opportunities for growth
- **Compounding Intrinsic Value**: Given the company’s ability to reinvest a majority of its earnings at very high rates of return combined with the significant prospects for growth, I estimate Tencent is compounding intrinsic value per share at a rate that is somewhere around **30% annually** at the current time

Growth will slow down from current rates, but given the competitive position of the business, the wide moat of WeChat, and the growth opportunities in its market, I think intrinsic value can compound at above average rates for many years to come.

Valuation – Long Growth Runway

- It has a small slice of various markets that are already huge, but still growing very fast
- Digital advertising is a $50 billion market, growing at 25%, will reach $100 billion in 3-4 years
- WeChat had just over $2 billion from ads in 2016 (compare to Facebook's $27 billion or Google's $79 billion in annual ad revenue)
- Facebook went from $2 billion to $27 billion in 6 years, and has huge margins and ROIC
- WeChat is in my opinion better positioned than Facebook in its respective market
- WeChat has one of the widest moats I've ever seen
- I believe it to be an "inevitable" – certain to take much more share of a growing pie over time

Tencent's Valuation Summary

- Roughly $8.5 billion in earnings in 2017 ($0.90 per share of TCEHY)
- 39.7% ROIC
- 34.0% Operating Margins
- 33.2% Incremental Returns on Capital (retaining most of its earnings to reinvest into growth opportunities)
- 47.7% Revenue Growth yoy
- My estimate of intrinsic value (earning power) compounding: 30-40% currently
- If growth averages half the current rate over the next five years, Tencent will be earning $22 billion (with still a lot of growth potential as it will still be a small fraction of China's large ecommerce and ad markets)
- Stock prices tend to track intrinsic value growth over long periods of time
- From the current price (~$35), I believe the stock has the realistic potential to compound at 15-20%+ over the next five years with very little risk of permanent downside

Tencent’s Wide Moat

1. WeChat – A Massive Network Effect
2. Long Runway for Growth
3. Great Business – free cash flow, recurring revenue, low capital required for growth, and very high margins
4. Founder/Operator focused on long-term user experience (the “most important moat”)
5. Reasonable Valuation and Attractive Future Prospects

Questions / Comments?

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Thank You!