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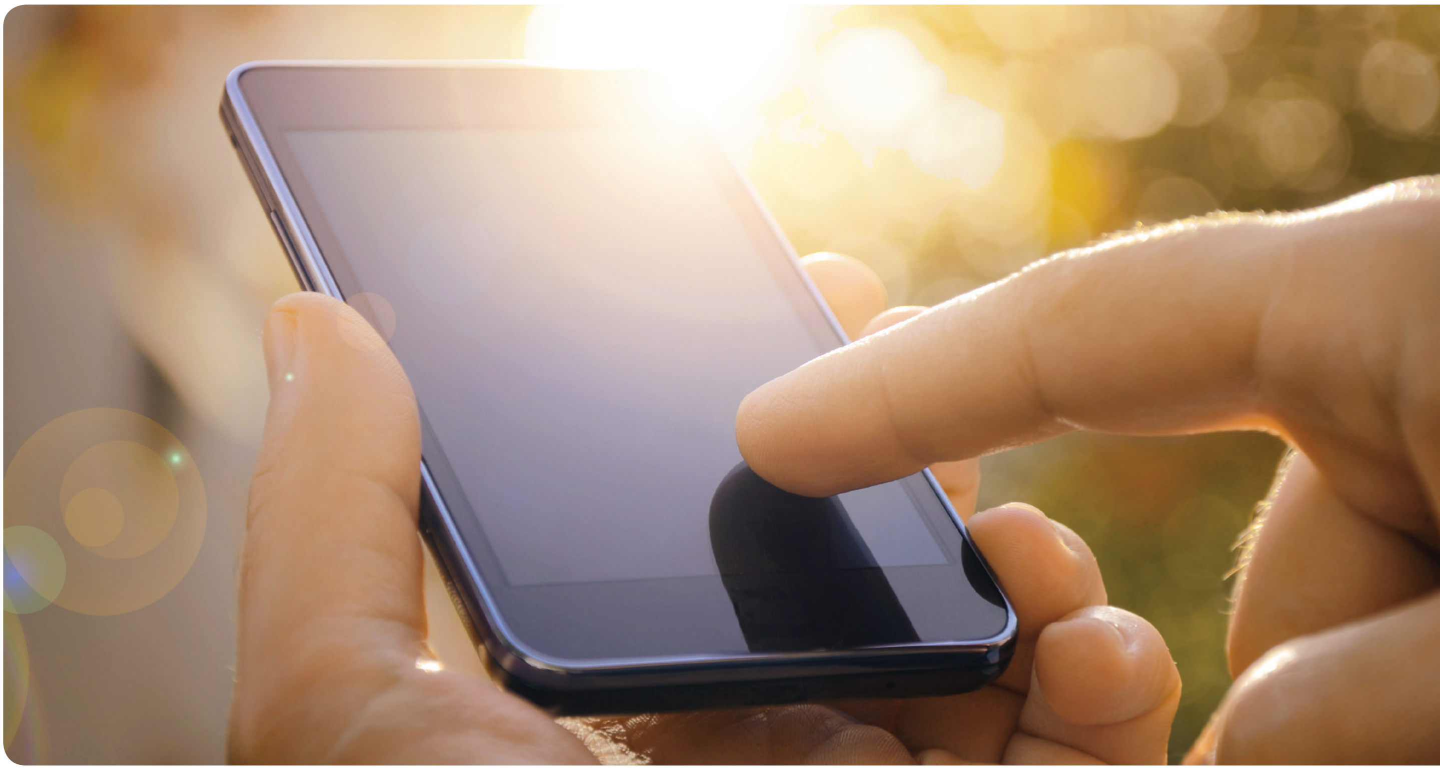


MAKING MOBILE MATTER

NASPERS POLARISES OPINION

Naspers has been an exceptional investment over the last decade, but now polarises opinion amongst South African investors. Some expect the share to be another "ten bagger", while others confidently predict that it will collapse in a heap. Our thesis is not so binary. While we do not expect the growth trajectory of Naspers to be as explosive as in the past, we expect Tencent earnings growth, coupled with an unwind of significant e-commerce losses in the core business, to support share price appreciation over the medium term.

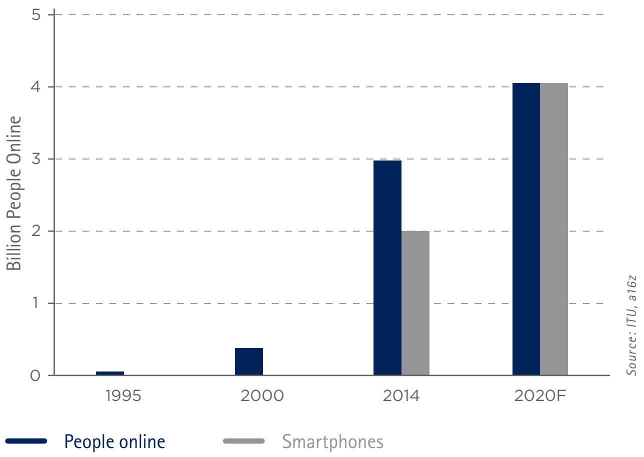
A MOBILE DEVICE IN EACH HAND

The world of commerce and communication has already shifted online; this is nothing new. What we are now seeing is a continued and accelerating shift from desktop to mobile, with similar trends evident from the United States to China, and everywhere in between.

These trends have enabled significant disruption to many incumbent industries, with the most successful mobile platforms becoming increasingly profitable and sought after. As a result, companies such as Tencent, owner of the Weixin (WeChat) platform, are showing accelerating revenue growth as they leverage their leading mobile "ecosystem" into new areas, grow their user base and sell more advertising. We believe Tencent's advertising opportunity is under-appreciated and still undervalued by the market, and as a result hold Naspers in all our balanced funds.

As internet connectivity has rolled out in emerging markets, so too have smartphone prices reduced drastically. One can now buy a new, high quality 4G-enabled smartphone for under $100. This has driven rapid adoption, as indicated in the graph below.

Chart 1: From 40 million people online to 4 billion



SIZE COUNTS

In tech there are many losers and few winners. The big get bigger. In fact they become VERY big, as an increasing user base enables them to spend large sums of money to enter new categories in a race to keep users engaged.

This is true in all regions where one social network operator and one search engine survive successfully, from Facebook and Google in most developed markets, to mail.Ru and Yandex in Russia and Tencent and Baidu in China. The result is a select group of juggernauts with colossal user bases. Both Google and Facebook have numerous properties with well over 1bn monthly active users.

ITS NOT ALL ABOUT GAMES

Although PC and mobile gaming still contribute around half of Tencent's revenues, the company owns numerous platforms including China's leading social network, messenging apps, news portal, app store, mobile browser and content libraries. In video, Tencent is number one in mobile video views across its various platforms (think a Netflix and YouTube hybrid), and owns the leading literature and music libraries. The company also owns material stakes in JD.com (think Amazon), 58.com (think Gumtree or OLX), Didi Kuaidi (think Uber, latest valuation round at over $20bn), Dianping (all things O2O) and WeBank, amongst others.

At Tantalum we are most excited about the mobile advertising opportunity that the company has, primarily through Weixin. Since its launch in 2011, Weixin has grown from a simple messaging app into a cultural phenomonon with almost 700m users, and is now the undisputed number one Chinese internet platform. It allows its users to chat, share their experiences, photos and updates via "Moments" (the app's social network-like newsfeed), shop via JD.com and 58.com, request cabs, book restaurants, make payments and apply for loans.

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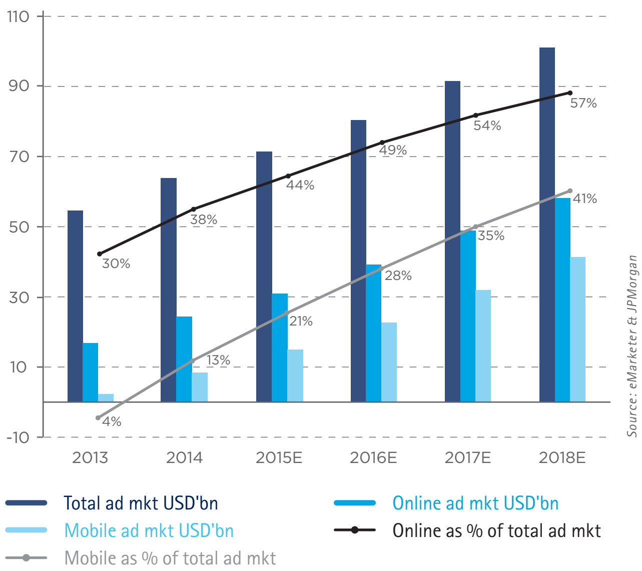
Weixin targets more affluent smartphone users, tilted towards white-collar city dwellers who are extremely engaged, with over 60% of users accessing the app more than 10 times a day, and almost 40% of users using it over 30 times per day. On average users spend almost an hour a day in the app (similar levels to Facebook in the US, but over double the global Facebook average). One third of Weixin users are active for over 2 hours per day. Extracting cash from this user engagement is key. Importantly for advertisers, users have shown intent to transact, with over 80% of users having bought goods online and over 300m bank cards being linked.

Moments stands out as the largest potential new advertising opportunity on Weixin, followed closely by Official Accounts. Broadly similar to Facebook, Moments is in the earliest stages of monetisation, and we expect mobile advertising to evolve much as it has on Facebook. The company is in the testing phases of Moments ad sales, with one advert delivered per user every 48 hours, compared to Facebook's ad load of 1 ad per 10 posts. For now Tencent is more concerned with perfecting its ad targeting technology, improving its automated ad bidding exchange and helping large advertisers to produce ads of the correct format with a social angle.

To assess the size of this potential advertising opportunity, we must of course first understand the Chinese advertising landscape, and then try and apply that to Tencent. The Chinese advertising market has developed differently to that of the US or the UK. In size terms, Chinese advertising as a percentage of GDP is only 0.6%, versus over 1% in the US and the UK. The vast size and complexity of the country resulted in a fragmentation of traditional advertising media. This, coupled with extreme levels of regulation and a historically closed society, resulted in traditional print and TV advertising never quite reaching the levels achieved in Western markets, and online advertising taking a greater share of the pie (44% share of total advertising in China, versus 33% in the US). This is expected as, in addition to the factors outlined above, Chinese internet users have shown a faster and larger propensity to transact online than Western peers, with the Chinese online shopping market around 1.5x that of the US in US$ terms and growing faster.

Chart 2: China advertising market



In essence, we expect the total advertising market in China to keep growing, closing the gap to GDP versus Western peers. Within this, we expect online to continue developing at a faster rate, as platforms such as Weixin offer advertisers a way to reach a large portion of the population in a targeted manner using big data. Rising income levels, growing retail sales and further penetration into lower tier cities offer tailwinds for growth. The Chinese online advertising market is thus forecast to grow at a 3 year CAGR of 23% to $58bn in 2018.

As previously outlined, Tencent has nascent advertising opportunites in three main avenues, namely Weixin Moments, Weixin Official Accounts and Tencent Video. In addition, Tencent has a further opportunity in mobile search via Sogou, where it is increasing its market share. We therefore believe that Tencent will grow its ad revenue well ahead of the overall online market by taking share from its key competitors. Chinese online advertising has traditionally been dominated by e-commerce and search, with a 28% and 34% share respectively. Alibaba and Baidu, with their mature business models, have been the key beneficiaries. As Tencent operates China's only social network and leading mobile video platforms, we look to the US to see what sort of share Facebook and YouTube command. In 2015, Facebook mobile advertising accounted for 11% of US online advertising, and YouTube 6%, per our calculations. We believe that Tencent will grow its market share significantly in China, mirroring what its US counterparts have achieved, as it further refines its advertising model. Currently, Tencent's mobile advertising revenue market share is only 5%, with Moments making up a negligible portion thereof.

Chart 3: Online advertising market shares in China and the US

	2015
Facebook	14%
Mobile	11%
Desktop	3%
Google	54%
Core business	48%
YouTube	6%
Other	32%
United States Total	100%
Tencent	9%
Mobile	5%
Desktop	4%
Baidu	32%
Other	59%
China Total	100%
Tencent Moments as % of total	<1%

Source: Company data, Tantalum calculations, eMarketer, Morgan Stanley

A basic analysis, in which we assume that the Moments and mobile video market shares converge in 2018 to what Facebook mobile and YouTube achieved in 2015, indicates a potential 2018 mobile revenue opportunity of over $10bn from these two initiatives alone (compare this to Tencent's current total revenue of $16bn). It is important to bear in mind that neither Facebook nor YouTube have reached their full advertising potential in the US, and are still growing this revenue strongly.

The above analysis excludes any potential from Tencent's mobile search app, which we believe is starting to steal market share from Baidu. A further opportunity relates to Weixin Official Accounts. Official Accounts equate to a company such as Nike becoming a direct contact on a user's messaging app. Companies use this as a mechanism to foster more direct, two-way communication between themselves and millions of current and potential customers. Interestingly, WhatsApp, which was acquired by Facebook for $19bn but has never produced meaningful revenue, is now focusing on similar official accounts, effectively "copying" what Tencent has pioneered.

The big threat to this analysis and forecasting is of course changing behavioural patterns. Tencent is known to be a patient operator when it comes to monetisation, and will continue to focus on optimising the user experience, ensuring that the best advert is served to the right consumer in a non-intrusive manner. The company is spending significant time and resources on ad targeting technologies. Again, Facebook provides a good peek into the future – in its recent quarterly results, the company grew North American average revenue per user by 50%, which highlights how much more advertisers will pay once a platform exhibits engaged users and effective ad targeting.

O2O

A more recent development, driven by the explosion of smartphones, is a blurring of lines between the online and offline commercial worlds. This phenomonon is referred to as O2O (online to offline), and has resulted in some large opportunities and even larger valuations, with Uber being valued at $62.5bn in its latest funding round. Although Uber, Airbnb, Apple Pay and Just Eat are the well-known global leaders, O2O extends into restaurant bookings, selling second hand goods, money transfer and wealth products, utility payments, location-based advertising and much more. While O2O is generally an attractive, "clip-based" business model, competition is rife in most markets and advertising spend is immense. Early stage J-curves are evident and profitability is only a promise.

Tencent's approach to O2O is to use it as another means of driving user engagement, and using this engagement to drive revenue from advertising on platforms such as Weixin. The company has taken minority stakes in various O2O ventures, side-stepping some of the high set-up costs whilst opening up their massive user base to these new partners. Tencent views O2O as a way of enriching the user experience, leading to a more engaged user who is willing to spend, which in turn leads to advertisers paying more per ad. Importantly, the O2O trend also supports Tencent's rapidly growing payment service.

The exact timing of revenue from these promising opportunities is difficult to forecast, but we believe the sheer quantum of opportunity will support Tencent earnings growth of over 30% p.a. over the medium term.

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VALUATION

On a forward PE of 24x (excluding cash and investments), Tencent is by no means cheap, but we believe the counter offers value considering its very solid growth outlook, and various other emerging initiatives such as micro loans via WeBank, original video content sales (similar to Netflix) as well as its growing payments business, which is currently loss-making. Having comfort around the Tencent investment case makes us happy holders of Naspers, where we believe further opportunities in the residual businesses (the "stub") remain, even allowing for a growing holding company discount. This media behemoth may not be sprinting as quickly as in the past, but still has a lot of legs left in it as a blue chip holding.