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Tencent Holdings Limited: An IPO Case Study

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Abstract

The purpose of this case study is to empirically investigate the phenomenon of initial public offerings (IPOs) by applying it to Tencent Holdings Limited (Tencent). Tencent is a Chinese internet and telecommunications value-added service provider that launched its IPO on 16 June 2004.

Tencent is China's largest internet firm and Asia's most valuable brand, boasting a current market capitalization of HK$1.224 trillion (US$157.9 billion). The origins of Tencent's success story trace back to its IPO decision, an important topic in the field of finance.

The aim of this study is to investigate the structure of Tencent's IPO, its listing decision and determining an intrinsic value of its IPO shares on its listing date.

It was found that Tencent's IPO extensively relates to academic literature surrounding IPO underpricing and valuing unlisted companies. The results reveal that Tencent left money on the table by underpricing its offer shares and exercised its over-allotment option as a form of price stabilization. It was further found that Tencent's underpricing was not influenced by competitor IPOs but rather by stringent IPO allotment policies and other signals of firm quality. It was also discovered that there may have been bias in the allocation of Tencent's shares.

An investigation into Tencent's listing on the Hong Kong Stock Exchange (HKEx) revealed that while its competitors listed on the NASDAQ Stock Market, there was a clear correlation between Tencent's operations and corporate structure to the HKEx listing and regulatory requirements. The decisive factors included domiciling in the British Virgin Island and Cayman Islands, the cost of listing on the HKEx Main Board versus the NASDAQ National Market as well as the effects of US GAAP and the Sarbanes-Oxley Act of 2002.

The study was concluded with the application of a relative valuation and discounted cash flow (DCF) valuation. The relative valuation estimated a price range of HK$14.40 - HK$18.72 for Tencent's IPO shares, while the DCF estimated the intrinsic value of the shares to be HK$18.68. The analysis was comprehensive and in-depth and suggests that Tencent's IPO shares were five times undervalued and were offered to shareholders at a deep discount.

Declaration of Authorship

I, Dario de Wet, declare that this thesis titled, `Tencent Holdings Limited: An IPO Case Study' and the work presented in it are my own (except where acknowledgements indicate otherwise). I confirm that:

- This thesis was submitted in fulfillment of the degree of Master of Business Science at the University of Cape Town.
- Neither the whole work nor any part of this thesis has been, is being, or is to be submitted for another degree or any other qualification at this University or any other institution.
- Where I have consulted the published work of others, this is always clearly attributed.
- Where I have quoted from the work of others, the source is always given. With the exception of such quotations, this thesis is entirely my own work.

Signed: 

28 April 2015

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I dedicate this thesis to my dear parents Leon and Lilia de Wet. You have always placed utmost confidence in everything that I do and have encouraged me to give of my best no matter how difficult the circumstances. If it were not for your support, guidance and caring nature I would not have been where I am today. I am truly grateful for everything you have done for me throughout my life thus far.

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Definitions

B2C – Business-to-Consumer

BVI – The British Virgin Islands

C2C – Consumer-to-Consumer

CAGR – Compound Annual Growth Rate

CAPEX – Capital Expenditure

CAPM – Capital Asset Pricing Model

CCASS – The Central Clearing and Settlement System

CGT – Capital Gains Tax

DCF – Discounted Cash Flow

DDM – Dividend Discount Model

DSL – Digital Subscriber Line

EBITDA – Earnings Before Interest, Taxes, Depreciation and Amortization

EIM – Enterprise Instant Messaging

EIT – Enterprise Income Tax

EPS – Earnings Per Share

EVA – Economic Value Added

FCFE – Free Cash Flow to Equity

FCFF – Free Cash Flow to the Firm

FDI – Foreign Direct Investment

GAAP – Generally Accepted Accounting Principles

GDP – Gross Domestic Product

GPRS –General Packet Radio System

GSM – Global System for Mobile Communication

HKEx – The Hong Kong Stock Exchange

HKFRS – Hong Kong Financial Reporting Standards

HKGEM – Hong Kong Growth Enterprise Market

HKSCC – Hong Kong Securities Clearing Company Limited

HLT – Highly Leveraged Transactions

HSBC – Hongkong and Shanghai Banking Corporation Limited

HSCI – The Hang Seng Composite Index Series

HSI – The Hang Seng Index

IDC – International Data Corporation

IDG – IDG Technology Venture Investments

IFRS – International Financial Reporting Standards

IM – Instant Messenger/Messaging

IP – Internet Protocol

IPO – Initial Public Offering

ISDN – Integrated Services Digital Network

ISP – Internet Service Provider

IVAS – Internet Value-Added Services

IVRS – Interactive Voice Response

JSE – Johannesburg Stock Exchange

LAN – Local Area Network

MIH – Myriad Investment Holdings

MMORPG – Massive Multiplayer Online Role-Playing Games

MMS – Multimedia Messaging Service

MNC – Multinational Corporation

MVAS – Mobile Value-Added Services

MVL – Millennium Vocal Limited

MXCN – Morgan Stanley Capital Index (also referred to as the MSCI China Index)

NASDAQ – NASDAQ National Stock Market

NPV – Net Present Value

OTC – Over-The-Counter

PHS – Portable Handyphone System

PRC – The People's Republic of China

R&D – Research and Development

RTS – Real-Time Strategy Games

RTX – Real Time eXchange

SEHK – The Stock Exchange of Hong Kong Limited

SEO – Seasoned Equity Offering

SEZ – Special Economic Zone

SFC – The Securities and Futures Commission of Hong Kong

SINET – China's Science Information NETwork

SMS – Short Message Service

SOX – Sarbanes-Oxley Act of 2002

The Company – Tencent Holdings Limited

TM – Tencent Messenger

VAS – Value-Added Services

VoIP – Voice over Internet Protocol

WACC – Weighted Average Cost of Capital

WAP – Wireless Application Protocol

WFOE – Wholly Foreign-Owned Enterprise

WTO – World Trade Organization

XLT – Xialingtong PHS technology

Glossary

Active User Accounts – User accounts that have been accessed during a 30-day period.

A-Shares – These are shares in Mainland China-based companies that are only available to Mainland Chinese citizens. These shares trade on the Shanghai Stock Exchange and Shenzhen Stock Exchange only.

Book Building – This is the process whereby an underwriter determines the offer price for IPO shares based on the level of demand from institutional investors.

Bookrunner – This is the underwriter or lead manager of new equity, debt and security issues. In Tencent's case this was Goldman Sachs (Asia).

B-shares – These are shares in Mainland China-based companies that can be purchased by foreign investors. Foreign investors can only purchase these shares by adhering to currency regulations. Shanghai B-shares can only be purchased for US dollar denominations while Shenzhen B-shares can only be purchased in Hong Kong dollar denominations. These shares are only available on the Shanghai Stock Exchange and Shenzhen Stock Exchange respectively.

Broadband – An internet connection allowing for large amounts of data to be transmitted at once. The speed of broadband in the PRC and Hong Kong at the time of Tencent's IPO was at least 1.5 Megabytes per second.

China Mobile – China Mobile Communications Corporation and its affiliates, branches and subsidiaries.

China Netcom – China Network Communication Group Corporation and its affiliates, branches and subsidiaries.

China Telecom – China Telecommunications Corporation and its affiliates, branches and subsidiaries.

China Unicom – China United Telecommunications Corporation and its affiliates, branches and subsidiaries.

Clawback Provision – This mandates a transfer of offer shares to the public tranche of an IPO if the overall demand for the IPO is high enough to meet the stipulated HEKx application thresholds.

Cold IPO market – This is when IPO activity on the market is low and there demand for IPO offer shares is low.

Cooling-Off Period – Also known as the pre-IPO quiet period. This prohibits the IPO company from publicly enhancing its name or encouraging favorable attitudes towards its offer shares for a specific time period before listing.

Core Founders – These are the founding members of a company. In the case of Tencent the core founders are Ma Huateng, Zhang Zhidong, Zeng Liqing, Xu Chenye and Chen Yidan.

Daily User Hours – The total amount of hours IM users remained logged into Tencent's QQ network.

Digital Divide – The gap between those who have access to computers and internet and those who do not.

Dividend Discount Model (DDM) –This is an alternative company valuation tool. It is also used to calculate a company's cost of equity as an alternative to the CAPM model when conducting a discounted cash flow valuation.

Digital Satellite Link (DSL) – This family of technologies provides internet access by transmitting digital data. DSL operates at a speed ranging from 256 kilobytes per second to speeds in excess of 100 megabytes per second.

Dotcom Bubble – An historical speculative bubble of the 1990's which peaked in the year 2000. It was fuelled by over-optimistic market sentiment surrounding internet and technology stocks. Overvalued internet and technology companies encouraged rapid exponential growth of equity markets over this period.

Dotcom Crash – The collapse of the Dotcom Bubble resulting from the huge losses and poor financial performance of prior internet and technology company investments.

Economic Value Added (EVA) – This is a measure of a company's financial performance, calculated by deducting the firm's costs of capital from its net operating profit after tax.

Freemium Pricing Model – This is a pricing model whereby a company offers basic product and services for free and then charges users a premium for additional enhanced content and features.

Freeware – Software made available for free.

General Packet Radio System (GPRS) – This is a packet-based wireless communication service that operates at a speed of between 56 kilobytes per second to 114 kilobytes per second. It provides continuous internet connectivity to mobile phone and computer users.

Global Coordinator – Typically the global coordinator is referred to as the manager of the IPO, responsible for coordinating the activities of the lead manager and underwriter. In the case of Tencent the global coordinator, lead manager and underwriter was Goldman Sachs (Asia) LLC.

Global System for Mobile Communication (GSM) – This is the standard for digital mobile communication.

Greenshoe Provision – Also referred to as an over-allotment option, this permits the IPO underwriter to sell up to 15% more shares than originally allocated by the issuing company.

HK$ – The official currency of Hong Kong

Hot IPO – This is when demand for an IPO exceeds the amount of offer shares available. Typically the share price of the IPO firm rises considerably as it opens on the market.

Hot IPO market – This is a market in which there is lots of IPO activity and demand for offer shares is high.

H-Shares – Shares of a company incorporated in Mainland China and listed on the Hong Kong Stock Exchange.

IDG Technology Venture Investments (IDG) –.One of two venture capital firms that initially invested US$1.1 million for a 20% stake in Tencent Holdings.

Informed Investor – Informed investors are highly knowledgeable in the financial securities markets.

Institutional Investor – These are knowledgeable companies or organizations that trade in large amounts of securities. These companies or organizations receive preferential treatment and benefits.

Internet Diffusion – The spreading of internet connectivity across a geographical area.

Integrated Services Digital Network (ISDN) – This is a network technology providing internet access by supporting the digital transfer of voice and data traffic simultaneously. This operates at a maximum speed of 128 kilobytes per second.

Interactive Voice Response (IVRS) – This is a software application combining voice telephone input and touch tone keypad selection to provide responses in the form of voice messages, facsimiles, callback or emails.

IPO Overpricing – The percentage decrease in the value of an offer share from its offer price to the closing price on the first day of listing. This is expressed as percentage.

IPO Roadshow – This is when the IPO company travels around the country to present to analysts, fund managers and potential investors to generate excitement and interest in the IPO.

IPO Underpricing – The percentage increase in the value of an offer share from its offer price to the closing price on the first day of listing. This is expressed as percentage.

Lead Underwriter – Also referred to as the lead manager, this is usually an investment bank or a financial institution that works with an investment bank to organize an IPO. The lead underwriter assesses the issuing company to arrive at both a value for its offer shares and the quantity of offer shares to be sold. Once this syndicate is formed the shares are then sold to both institution and retail clients. In the case of Tencent the lead underwriter was Goldman Sachs (Asia).

Leave/Leaving money on the table – In the context of IPOs, this is when the IPO company underprices its offer shares by refraining from taking full advantage of expected market demand for its shares. As a result the actual offer price is set lower than what the company could have expected to achieve, further stimulating market demand for these shares.

Local Area Network (LAN) – This is a computer network that connects a variety of computers together to share a communication technology through a single line.

Lock-Up Period – This is a predetermined amount of time subsequent to an IPO, restricting controlling shareholders from selling their shares in the company.

Log-In Flash – These are targeted advertisements that are displayed as soon as an online user logs-in to their respective online platforms. Typically these appear directly after the log-in page and will either appear for a set duration of time or the user will have to click remove it.

Listing Rules – The rules governing the listing of securities on the Stock Exchange of Hong Kong Limited (SEHK). These are amended frequently.

Ma Huateng – The founder and CEO of Tencent Holdings Limited. Also known as Pony Ma.

Mandarin Sea Investments (Mandarin Sea) – A wholly owned North American subsidiary of IDG Technology Venture Investments (IDG).

MIH – Myriad Investment Holdings, a wholly owned subsidiary of South African multimedia conglomerate Naspers.

Millennium Vocal Limited (MVL) – One of two venture capital firms that initially invested US$1.1 million for a 20% stake in Tencent Holdings.

Multimedia Messaging Service (MMS) – This allows users to exchange multimedia through their mobile phones and other devices.

Naspers – A South African multimedia conglomerate listed on the Johannesburg Stock Exchange under the ticker NPN. Naspers originally purchased a 46.5% stake in Tencent in the year 2001. It currently owns holds a 34% stake in Tencent.

NASDAQ National Market – An American stock exchange.

Net Present Value (NPV) – The difference between the present value of cash inflows and cash outflows.

Offer Price – The final Hong Kong dollar price per offer share (exclusive of brokerage, stock exchange trading fees, SFC transaction levy and investor compensation levy).

Offer Shares – The Hong Kong Offer Shares and International Placing Shares of the IPO.

Online Community – A group of users that communicate or interact with each other through the internet.

Pacific Century Cyberworks Ltd – Pacific Century Cyberworks Limited was founded by Richard Li, son of Hong Kong business tycoon Li Ka Shing. It later became the PRC's leading telecoms operator by acquiring Hong Kong Telecom.

P Chip Stock – Chinese companies listed on the Hong Kong Stock Exchange, however they are incorporated in the Cayman Islands, British Virgin Islands (BVI) and Bermuda. These companies operate in Mainland China and are run by those in the private sector only.

Portable Handyphone System.(PHS) – This is referred to as Xialingtong in the PRC.

Price Stabilization – Tis is the process whereby IPO underwriters facilitate the distribution of securities on the exchange in an effort to ensure that the market price of the newly listed shares does not fall below the original offer price.

QQ – Tencent's popular instant messaging software and company brand.

QQ SKIN – The user interface, design and overall look of the QQ IM software.

Realtime Century Technology (Realtime Century Technology Limited) – This is a BVI-incorporated international business company established on 14 March 1997. It was a dormant company until it became a wholly-owned subsidiary of Tencent Holdings on 18 December 2003.

Red Chip Stock – Chinese companies incorporated internationally and listed on the Hong Kong Stock Exchange. These companies are controlled to some degree, or completely, by the Chinese government or a recognized Chinese government institution.

Registered IM user accounts – Accounts held by IM users who have registered for the service.

Registered users – Users who have signed-up to use an online service.

Renminbi – The official currency of the People's Republic of China.

Retail Investor – These are individual investors who buy and sell shares in their own personal capacity.

Shenzhen Unicom – The Shenzhen division of Chinese mobile network China Unicom.

Shidai Zhaoyang Technology (Shidai Zhaoyang Technology Limited) – Established in the PRC as a limited liability wholly owned subsidiary of Tencent Holdings Limited on 8 February 2004.

Shiji Kaixuan (Shenzhen Shiji Kaixuan Technology Company Limited) – Established in the PRC as a limited liability company on 13 January, 2004.

Short Message Service (SMS) – This allows text messages to be transmitted through mobile phones.

SIM card – This is an electronic card inserted into mobile handsets. It contains all personal mobile number of the user, identifying the network they belong to.

Simultaneous Online User Accounts – All user accounts accessing an online service at the same time.

Spamming – This entails using electronic message systems and platforms to send messages indiscriminately. This is commonly associated with online advertising.

Special Economic Zone (SEZ) – These are granted special economic policies and tax benefits when compared to other economic zones within the PRC.

Sponsor – This is an influential investor who stimulates and creates demand for a stock.

System Messages – These are advertisements distributed in the form of a bulk message. These are usually in a picture format and give the user a choice to click on the picture and access more information about the respective product or service being advertised.

Tax Avoidance – This is a legal practice, and makes use of legal methods to modify a businesses or individuals financial situation to lower their income tax owed.

Tax Evasion – This is an illegal practice, whereby a business or individual avoids paying their true tax liability. This is a criminal offense subject to penalties and criminal charges.

Tax Haven – This is a state, country or territory offering foreign individuals and businesses little or no tax liability in a politically and economically stable environment. Furthermore, they too provide little or no financial information to tax authorities.

Tax Holiday – A temporary reduction or elimination of tax.

Tax-shield benefit – This reduces the cost of debt incurred by a company and increases as a company takes on greater amounts of debt.

Tencent Computer (Shenzhen Tencent Computer Systems Company Limited) – Established in the PRC as a limited liability company on 11 November 1998.

Tencent Technology (Tencent Technology Shenzhen Company Limited) – Established in the PRC as a limited liability wholly owned subsidiary of Tencent Holdings Limited on 24 February 2000.

Tencent Limited – This is a BVI-incorporated international business company established on 14 March 1997. It was a dormant company until it became a wholly-owned subsidiary of Tencent Holdings on 18 December 2003.

Tencent Holdings Limited – Also referred to as 'the company', Tencent Holdings Limited was incorporated in the British Virgin Islands on 23 November 1999. It redomiciled to the Cayman Islands on 27 February 2004.

The Central Clearing and Settlement System (CCAS) – Operated by the Hong Kong Securities Clearing Company Limited.

Uninformed Investor – These investors have no knowledge of the securities markets or financial securities whatsoever.

US$ – The official currency of the United States of America.

Wholly Foreign-Owned Enterprise (WFOE) – This definition is specifically applicable to PRC law. This is a Chinese investment vehicle in the form of a limited liability company that is funded by foreign investors. It is the most flexible form of foreign investment in China. Tencent's WFOEs are Shidai Zhaoyang Technology and Tencent Technology.

Wireless Application Protocol (WAP) – This is an open, global specification allowing internet access and other broadband access via mobile devices.

Preamble

All information contained in this document pertains to Tencent's IPO listing on 16 June 2004. Unless otherwise stated all analysis, interpretation and conclusions are based only upon information that relates to the time period up to and on 16 June 2004.

All information referred to within this document was obtained from Tencent's prospectus document, unless otherwise specifically stated. All other sources have been referenced according to the Harvard referencing system.

Chapter 1: Introduction

This dissertation analyzes Tencent Holdings Limited (Tencent) and its initial public offering (IPO) on 16 June 2004.

An IPO is the first time a private company sells its shares to the public. A private company could decide to IPO for numerous reasons. Typically, this is because the company wants to gain access to funding through capital markets. This can improve the company's image while motivating management and employees of the new publicly listed entity. These benefits create the opportunity for the company to grow organically and expand its operations, with the end goal of creating value for its shareholders.

However, the newly listed entity will incur costs associated with going public. The IPO company will face stringent regulatory requirements from prospective exchanges. These include public market compliance costs as well as transparency and disclosure obligations. The company will also incur listing fees, both upfront on the day of listing and an annual listing fee each year.

The largest cost incurred by the IPO company is the loss of control. By publically listing, the IPO company will be placed under greater scrutiny by various stakeholders. In order to create value for its stakeholders, the IPO company's operational and strategic flexibility will be limited. This is because management is expected to make decisions in the best interests of the company's stakeholders to ensure that this goal is achieved.

There are many factors to take into consideration for an IPO to be successful. The timing of the IPO on the market is crucial to the level of demand achieved by the listing company. The best time for an IPO company to list is when the market is hot, with high volumes of IPO activity and consequential high demand from investors. If a private company was to launch its IPO in a cold market then the lack of IPO activity and poor demand would ensure the IPO company does not reach its intended levels of capital to be raised.

IPO underpricing is a common occurrence which affects the overall level of investment secured by the IPO company. This influences the performance of its share price in the long-run. By leaving money on the table the underwriters of the IPO company stimulate excess demand by pricing the IPO shares below market value. This encourages investors to participate in the IPO while mitigating the risk of uncertainty surrounding the level of demand and resultant success of the IPO.

1.1 Tencent Holdings Limited

South African multimedia conglomerate Naspers's (Myriad Investment Holdings) 34.0% investment in Tencent is one of the most successful corporate investments to date and has attracted strong international media attention.

However, the origins of this financial success are specifically attributable to the Tencent IPO. Had it not been for Tencent's decision to publicly list, both Tencent and Naspers may not have achieved their current levels of commercial success.

From failing to attract local private investment in its early years to launching its IPO amidst weak global market sentiment, Tencent overcame significant challenges in going public.

Tencent was the first Chinese internet and telecommunications value-added service company to list on the Main Board of the Hong Kong Stock Exchange (HKEx). In contrast, Tencent's competitors listed on the NASDAQ Stock Market (NASDAQ) four years prior to the launch of its IPO in 2004. This highlights issues around the stringent listing requirements for the HKEx and the unique challenges surrounding the listing procedures in the Hong Kong equity market. In addition, the timing of their listings meant that Tencent's competitors took advantage of the 2000 Dotcom Bubble before it crashed later that year.

In contrast, Tencent's IPO was surrounded by negative global market sentiment towards internet and technology stocks, whereby consequential underpricing was undertaken to stimulate investor demand. This achieved an oversubscription of 159 times its public tranche accompanied by a 17

times oversubscription in its placing tranche, generating overwhelming demand for its offer shares and exceeding analyst expectations.

This study empirically investigates the phenomenon of initial public offerings (IPOs) by applying it to Tencent. It explores the structure of Tencent's IPO, its listing decision and determines an intrinsic value of its IPO shares on its listing date. As such, it explores academic literature surrounding IPO underpricing theory and theories on valuing unlisted companies. Furthermore, it applies IPO underpricing theory to Tencent and explores the effect of post-IPO subsequent events on Tencent's market performance for the period ending 30 June 2005.

The full structure and approach of this dissertation is addressed in the following section.

1.2 Structure

This dissertation has been structured in the form of an IPO case study on Tencent. This approach ensures that the IPO phenomenon can be explored in-depth and understood in a real-life context by critically analyzing Tencent's IPO. This provides an opportunity to derive value from this study using critical insight and analysis of Tencent as a company, the Hong Kong equity market and China's internet and telecommunications value-added service industry.

By providing contextual information on Tencent and its IPO, the causal links between actual IPO activity and financial theories are established. This case study ensures that these academic theories surrounding IPO underpricing and valuing unlisted companies can be tested and developed by applying them to this case. It provides the reader with sufficient information to conceptualize the IPO process from the perspective of Tencent and to explore pertinent IPO-related issues in the same manner as industry analysts.

A breakdown of the various subsections has been provided below.

1.2.1 Research Methodology

This section theoretically and practically justifies the suitability and adoption of the case study research method in achieving the research objectives of this dissertation.

It uses academic literature as a basis to explore case study research in finance, assessing the suitability of this research method by applying various academic notions to the Tencent IPO. In emphasising its relevance, this section addresses the value of adopting the case study research method by highlighting practicality and skills development, simplicity and effectiveness as well its rich levels of insight. It further investigates the commonly misperceived pitfalls of this research method, disproving the misperceived lack of theory, reliability and validity of the case study method.

1.2.2 A Critique of Academic Literature surrounding IPO Underpricing Theory and Valuing Unlisted Companies

This section critically explores academic literature surrounding IPO underpricing theory and theories on valuing unlisted companies. This serves as a theoretical framework for the case.

It investigates the occurrence of IPO underpricing in the Hong Kong equity market with emphasis on asymmetric information models, institutional explanations and theories surrounding ownership and control. Specifically, the underpricing theories explored are 'The Winner's Curse', underpricing as a signal of firm quality, price stabilization, underpricing as a means to retain control and underpricing as a means to reduce agency costs.

Academic literature suggests that the absence of public market exposure will affect the underlying valuation methodologies applied to unlisted companies. In order to ensure that one is able to determine the intrinsic value of an IPO company on its listing date, relevant considerations must be undertaken to ensure a fair and accurate result. This study explores this literature in the context of the valuation methods undertaken to value IPO firms and the effect of accounting data and firm-specific factors when conducting these valuations.

1.2.3 The Case Background

The case background provides an extensive, in-depth analysis into Tencent's company history and the Chinese internet and telecommunications value-added service industry. It explores the origins of the Tencent group, the evolution of its business model, company growth and its investment strategy leading up to its IPO listing date.

This information was derived from various sources, including the China Daily newspaper's website, the Hong Kong Stock Exchange (HKEx) News, Tencent's IPO prospectus, Tencent's official company website, the JSE Stock Exchange News Service (SENS) and Naspers's Annual Report.

The case constitutes an integral part of this dissertation, providing a comprehensive foundation in order to explore the various questions raised within this study. The case culminates by exploring the intricacies surrounding the construct of Tencent's IPO offering and the premise behind the company's decision to list on 16 June 2004.

1.2.4 The IPO Listing Decision

This section is primarily based on insights gleaned from both case-related information and relevant IPO listing theories.

Historical industry analysis has shown that the majority of Tencent's direct competitors publicly listed on the North American NASDAQ National Market in the 2000 financial year. This was during the Dotcom Bubble when global internet companies were achieving valuations far above realistic industry expectations at the time. Many of Tencent's direct Chinese competitors benefitted from this trend and listed on the NASDAQ Stock Market in that same year.

This suggests two topics of importance surrounding Tencent's listing decision. Firstly, Tencent's decision to list comes four years after its industry peers. Secondly, the company's decision to list on the Main Board of the Hong Kong Stock Exchange (HKEx), instead of the NASDAQ National Market as in the case of its competitors, is worthy of investigation.

This may suggest that the company has bucked industry trends in favor of benefitting strategically from an alternative listing platform at a later point in time. This study explores this notion to clarify and understand both the strategic and financial considerations behind Tencent's IPO listing decision.

Specific relevant points addressed in this study include the differences in company registration between the British Virgin Islands (BVI) and the Cayman Islands, the differences in IPO fee structure behind the HKEx Main Board and NASDAQ National Market, the differences between IFRS and US GAAP and the effects of the Sarbanes-Oxley Act of 2002 on this listing decision.

1.2.5 A Complex Valuation of Tencent Holdings Limited

With Tencent's confirmed offer price of HK$3.70 per share, the company priced its offer shares at the top of its HK$2.77 – HK$3.70 price range. The significance of this was the ability to convert the offer price into feasible market demand for these shares. While Tencent's IPO shares were heavily oversubscribed, it is important to understand not only *how* Tencent decided on this offer price, but more specifically whether these shares were underpriced or overpriced in the market.

In doing so, a meticulous analysis has been undertaken into the company's historical financial performance, its capital structure; and the past, present and future status of the industry climate. This study includes both a relative/comparable valuation of Tencent as well as a discounted cash flow (DCF) valuation using the unlevered free cash flow to the firm (FCFF) approach. Based on these valuation methods, it explores the relationship between the estimated intrinsic value of Tencent's offer shares and IPO underpricing theories.

1.2.6 Underpricing the Offer Shares and Post-IPO Subsequent Events

Based on first day market returns, Tencent's offer shares were underpriced by 12.2%. This section explores the likely reason for the occurrence of this underpricing. This is done by applying relevant IPO underpricing theories to Tencent's IPO.

These IPO underpricing theories are ‘The Winner’s Curse’, underpricing as a signal of firm quality, price stabilization, underpricing as a means to retain control and underpricing as a means to reduce agency costs.

Furthermore, this section provides an overview of Tencent’s market performance over the one-year period ending 30 June 2005. It specifically explores the effects of certain post-IPO subsequent events and how these events have affected both trading volumes and consequently Tencent’s share price over this period.

The remainder of this dissertation is structured as follows: Chapter 2 explores the research methodology undertaken, substantiating the use of the case study research method for this dissertation. Chapter 3 is a literature review exploring IPO underpricing theory and theories on valuing an unlisted company. Chapter 4 is the case, setting context for the case study by providing extensive background information surrounding Tencent, its IPO deal and the Chinese value-added service industry. Chapter 5 explores Tencent’s IPO listing decision and the differences between the HKEx and NASDAQ that may have influenced this decision. Chapter 6 provides a complex valuation of Tencent’s IPO offer shares as at 16 June 2004 using both a relative valuation and DCF valuation model. Chapter 7 applies IPO underpricing theories to Tencent’s first day’s market performance, while exploring the effects of post-IPO subsequent events on Tencent’s share price for the period ending 30 June 2005. Chapter 8 concludes the case study.

Chapter 2: Research Methodology

This dissertation has adopted the case study as the preferred research approach in exploring the phenomenon of IPOs. The case study research method is defined as "an empirical inquiry that investigates a contemporary phenomenon within its real-life context; when the boundaries between phenomenon and context are not clearly evident; and in which multiple sources of evidence are used." (Yin, 1984:23).

In this context, the case study research approach ensures that one can effectively investigate and understand the IPO phenomenon by interpreting it within a real-life context. This is done by investigating Tencent's IPO listing decision (see Section 1.2). This provides a new perspective on IPOs, complimenting existing finance-based academic research; a clear strength of adopting this research method (Bengtsson and Larson, 2012: 6). Considering Tencent's current market position, the relevance of IPOs and their causal link to the success of past and present technology, telecommunications and media (TMT) based companies, the case study research method ensures an extensive and in-depth investigation to achieve an holistic understanding of IPOs (Baharein and Noor, 2008:2).

2.1 Case Study Research in Finance

While the origins of case study research methods were initially established within the field of social sciences, it is clear from the above that it is a practical way to investigate complex phenomena in the world of finance (Stoner and Holland, 2004: 42). This viewpoint is supported by Bettner Robinson and McGuon (1994: 1, 11, 14) who believed that the adoption of case studies will help to shape the future direction of academic research in finance.

Historically, case study based research methods are a rarity in finance, with lower submission rates in comparison to traditional research methods (Bengtsson and Larson, 2012: 3). Eisenhardt and Graebner (2007: 26) found that many researchers tend to refrain from adopting the case

study approach because it heavily reduced the possibility of publishing. They attributed this to the skeptical views of reviewers and editors who were more inclined to nomothetic research methods and most likely did not fully understand the true essence of case studies.

However, the popularity of case study research has increased over time (Stoner and Holland, 2004: 3). This has been attributable to its frequent use in managerial and organisational accounting research, accompanied by the supportive climate of the United Kingdom and Europe for qualitative research methods in the fields of accounting and finance (Stoner and Holland, 2004: 50).

Applying case study methodology to finance-based research, in a 2012 study pertaining to the relevance of case studies in mergers and acquisitions (M&A), Bengtsson and Larson (2012:14) concluded that it was a powerful and underutilised research method. In this light, they further found that case studies provided a unique and valuable approach to M&A research.

Stoner and Holland (2004: 50) also used this traditionally unconventional research method, applying it to their research in finance. This encouraged unique findings and helped to ensure the successful publication of their research paper. This dissertation has been structured along similar lines. Hence, it offers a unique and unconventional research approach to exploring IPOs.

2.2 Assessing and Applying Case Study Research Methodology

2.2.1 Assessing the Suitability of the Case Study Research Method

In determining the suitability of the case study approach to the research objectives of this dissertation, Baxter and Jack (2008:2) have raised four primary questions. A case study approach is the most appropriate avenue of research methodology when (a) the focus of this research is to answer questions on “how” and “why” certain events have occurred, (b) it is not possible to influence the behaviors of those involved in the study, (c) the writer wants to reveal contextual

conditions as they are believed to be relevant to the greater phenomenon or (d) when the boundaries between the linkages of a phenomenon and its context are unclear.

In applying these guidelines, it is clear that this dissertation meets all four of these conditions appropriately. It explores both the "how" and "why" questions from multiple perspectives. This dissertation raises the question of how and why Tencent originated, how Tencent has evolved over time, why Tencent decided to IPO, how Tencent decided upon listing on the Hong Kong Stock Exchange (HKEx), how Tencent created sustainable value in its IPO shares and why Tencent priced its IPO shares at the levels it did. This approach comes full circle when linking this contextual case to both how and why the Tencent IPO case correlates with academic literature surrounding IPO underpricing theories and theories on valuing unlisted companies.

Congruent with Baxter and Jack's (2008: 2) guidelines, it was not possible to influence or manipulate the behaviors of those involved in this study. This is because all data sources pertained to and were limited to the objective mediums as outlined in Section 1.2.3 only. This approach is supported by Rowley (2002: 3), who motivates that by using a variety of different sources, the case study approach goes beyond the norms associated with the limited range of sources to which other historical research methods are accustomed.

Consequently, this dissertation uses a variety of sources in order to answer specific research questions. This is a key characteristic of the case study approach (Gillham, 2000: 1, 2). While it is evident that this dissertation makes use of a variety of both qualitative and quantitative sources, case study research methodology is best undertaken using a combination of both data types (Yin, 1981:1; Flyvbjerg, 2006: 27). The benefit of adopting this research method is that qualitative data ensures there is a greater understanding of the topic at hand, while simultaneously providing context and meaning to quantitative data (Gillham,2000: 10).

Furthermore, based on the holistic findings of this dissertation, it is clear that the contextual conditions associated with Tencent's IPO are highly relevant to the IPO phenomenon in general. The Tencent story presents a unique case, providing a distinctive perspective and appreciation for IPOs. This goes beyond the norms of traditional IPO-based academic research.

It aims not only to identify and clarify these linkages but also to prove the existent synergies between generalist IPO theory, academic literature and the Tencent IPO.

By formulating a case study around Tencent's IPO, this enables one to investigate its IPO listing decision on a deeper and more complex level. In this context, the case study uses qualitative data effectively (together with quantitative data) to ensure direct exposure to the intricacies of Tencent's 2004 IPO deal. In this way, it provides an insider's view of the contextual situation at hand. This places greater emphasis on the ability to explore and investigate subject matter at levels that are potentially greater and more complex than what other traditional research methods may offer (Gillham, 2000:11).

This being said, the case study approach allows for both the researcher and reader to explore the subject matter in its natural setting. It provides a platform to identify its link to general theories relevant to the subject matter, and encourages both parties to appreciate and understand the complexities of these processes (Cable, 1994: 3). As a case study, this dissertation provides an opportunity to research and compare Tencent's IPO to its competitor's IPO. This promotes further industry research surrounding the contributing factors that may or may not have caused differences in the outcomes of these IPOs. This motivates a basis for further research on this topic within the finance industry and yields value in this regard (Widdowson, 2011: 2).

2.2.1.1 Description, Explanation, Prediction and Control

Woodside (2010: 11) offers an additional perspective on the adoption of case studies as a research method. In doing so, he proposes evaluation criteria in which there are four main research objectives that would indicate if the case study method is most suitable. These objectives are: description, explanation, prediction and control.

In formulating the case (as per Section 1.2.3), the description attribute sufficiently ensures that questions surrounding "who", "what", "where", "when" and "how" are adequately met. Not only does the Tencent case ensure that this information is available, but it ensures that this information is presented in a manner that allows for sufficient explanation around "why" specific

events or theories have arisen (see Section 1.2.4). In terms of the prediction objective, the descriptive and explanatory information presented within the case together provide the opportunity for effective forecasting (see Section 1.2.5).

While forecasting here is explicitly with reference to financial forecasting, this requires a holistic approach to interpreting and predicting the future movements and progression of numerous contributing factors. These factors are important because they could have had an integral effect on the overall value placed on Tencent's IPO shares. In terms of control, the structure and overall context of the case study approach enables the researcher to influence the reader's interpretation of the topic at hand. Hence, the intended goals of this dissertation as stipulated in Section 1.2, paragraph two.

Both Baxter and Jack (2008:2) and Woodside's (2010: 11) basis for criterion are further supported by Bengtsson and Larson (2012: 5) and (Crowe, 2011:4). They state that case studies are the most effective means of research strategy in answering "how" and "why" questions associated with research surrounding contemporary phenomenon. This ensures that existing academic theories are refined, while encouraging the development and interpretation of new academic theories relative to the topic.

2.2.2 A Precautionary Methodological Measure

Keeping with this notion, a fundamental characteristic of the case study research methodology is that one should not commit to using it with prior theoretical ideas in mind (Gillham, 2000:2). In doing so, this limits the true value of this research method. This is because it is nonsensical to apply generalist theories to case-specific data, as one must first formulate a complete understanding of the data relevant to the case. This is explicitly applied throughout this dissertation, and is evident throughout its structure.

Chapter 3 provides a critique of academic literature surrounding IPO underpricing theory and valuing unlisted companies. This literature review is placed prior to the actual case study to expose the reader to various academic literature surrounding IPOs in general.

The dissertation comes full circle in Chapter 7 where this academic literature is re-examined and applied to the case. This illustrates effective adherence to this fundamental characteristic highlighted above.

It allows one to develop an understanding of the overall subject matter *before* establishing the link between these theories and the Tencent case. This ensures that the integrity of the dissertation remains intact, proving to adhere to this common practise throughout its structure.

2.3 Value of Adopting the Case Study Research Method

2.3.1 Practicality and Skills Development

From an industry-related standpoint, it is common practice within finance to undertake the analysis and interpretation of an IPO company in the same direction as this dissertation. Both investment bankers and IPO investors will undertake significant amounts of research in investigating the IPO firm, with an essential goal to value its IPO shares (Gad, 2011:1).

As will be evident throughout this case, investment banks play a key role in the IPO process, acting as underwriters. However, in order for an investment bank/s to manage the IPO, it needs to present to the IPO firm's board of directors to prove its eligibility (INC, 1999:1). This presentation typically addresses concerns around underwriting experience, a preliminary valuation of the IPO firm and the relevant logistical concerns surrounding the investment bank.

Taking this into account, this dissertation's emphasis on the practical element provides a suitable proxy for the roles and responsibilities typically accustomed to this area within the finance industry. This exposes the reader to a variety of required industry-related skills.

The first skill identified is the ability to research effectively. Without this, the investment bank is less likely to fully master an understanding of the industry, how other IPOs within the respective industry have performed and how this relates to the IPO company at hand. Furthermore, an

accurate and substantiated preliminary valuation is less likely if this research is not succinct, relevant, impactful and of a generally high caliber. This notion is supported by Flyvbjerg (2006:6), who places strong emphasis on the importance of the case study in developing strong research skills, relating this to the importance of skills development for professionals across a broad range of industries. Hence, the case study research approach provides a benefit to the researcher as an effective proxy for the type of research required by investment banks.

The second skill identified focuses on the practical element of the research questions. This is where synthesising and interpreting case information will ensure that effective and relevant solutions are formed. Hence in light of undertaking the preliminary valuation, investment banking employees will need to interpret case information. This is to understand the IPO firm's industry, the historical significance and performance of IPOs within this industry and to use this together with company-specific information to formulate an accurate and justifiable preliminary valuation of the IPO firm. Hence, this is clearly represented through Chapter 6's complex valuation of Tencent's IPO.

2.3.2 Simplicity and Effectiveness

Throughout this dissertation there are multiple sections pertaining to complex information surrounding both IPOs in general, and with specific reference to Tencent's IPO. Academic literature is incorporated throughout, ensuring heightened levels of complexity. This is where the case study method holds a significant advantage over other traditional means of academic research. This is because it ensures that complexity can be simplified and understood by the reader (Bengtsson and Larson, 2012:6). This is supported by the findings of Eisenhardt and Graebner (2007:25), who deduced that the case study is one of the best forms of research methodologies as it promotes the synergy between qualitative evidence and mainstream deductive research.

Siggelkow (2007:1) supports these findings, stating that it is the most unique cases which motivate the adoption of the case study over other research methods. Contextually, as Asia's most valuable brand, Tencent's current market success served as motivation in developing the

respective research questions explored throughout this dissertation. This presented an opportunity not only to explore IPOs, but to create a conceptual argument behind Tencent's IPO process and to understand whether this proved to catalyse its success as China's largest internet firm boasting a market capitalization of HK$1.224 trillion (US$157.9 billion).

2.3.3 Insight

Traditional research methodology dictates a purely results-based analyses and interpretation of the research topic. In contrast, qualitative research methods, such as case study research, place emphasis on the *processes* leading to the outcomes/results instead. This is a critical motivating factor in choosing to use this research method in fulfillment of this dissertation's research objectives.

Therefore, unlike traditional research methods, this dissertation does not use a results-based approach to create intellectual value. Instead, this intellectual value is created by placing sole emphasis on the following: the ability to interpret and understand the process behind Tencent's decision to list, the premise for Tencent's actions surrounding its exchange of choice, the price of Tencent's IPO shares and the multi-faceted subject matter surrounding Tencent's ability to achieve its intended IPO-related objectives. This provides a completely unique perspective on the topic at hand, in which rich insight creates an opportunity for one to develop a holistic understanding of the general IPO process and how this applies to Tencent.

In order to successfully achieve this, significant emphasis has been placed on heightened levels of both insight and detail throughout this dissertation. This is because insight is deemed a key factor of success in case study research (Gerring, 2006: 7).The insight and detail evident throughout this dissertation provides a springboard for further areas of academic research surrounding both general IPO theories and individual subject areas which have contributed to Tencent's ability to list. This conveys the value within case study research, surpassing conventional research methods where such insight is not necessarily achievable (Rowley, 2002:2).

2.4 Pitfalls of Case Study Research

According to Flyvbjerg (2006: 4, 5), there is a negative bias against case study research because it is typically misunderstood. These can be summarised into five common misunderstandings: theoretical, context-independent knowledge is more valuable than concrete, context-dependent knowledge; no generalizations can be drawn from a single case study; case studies are not suitable for hypothesis testing or theory building, but are limited only for generating hypotheses; case studies are biased towards the researcher's viewpoint, and that due to the specificity of case studies, it is difficult to summarise and develop general theories.

Essentially, these pitfalls of the case study approach can be summarised into a lack of theory (2.4.1), reliability (2.4.2) and validity (2.4.3), when contrasted with other traditional research methods.

2.4.1 Theory

A common pitfall of case study research is the inability of researchers to ensure that their research remains within a defined scope (Baxter and Jack, 2008:3, 4). Researchers tend to present a topic that is too broad, which presents too many objectives to prove in one case study alone. This dissertation avoids this pitfall by defining its scope through the activities, time and place of the contextual topic under investigation. Therefore, this dissertation explores Tencent's IPO listing decision (activity) for the defined period dating 11 November 1998 to 16 June 2004 (time) on the Hong Kong Stock Exchange (HKEx) within the Chinese internet and telecommunications value-added service industry (place).

This proves that this dissertation effectively binds the case and nullifies this pitfall. This refutes a challenging aspect of the case study research method in which many researchers are privy to a lack of selectivity in their case information.

These researchers tend to incorrectly emphasise the descriptive element of the case and present information that is irrelevant to its conceptual argument (Siggelkow, 2007: 4 ; Rowley: 2002, 2).

2.4.2 Reliability

While some perceive the case study to present heightened levels of subjectivity and bias in its approach, this is not true (Flyvbjerg, 2006: 20). Heightened levels of subjectivity and bias are considered risks applicable to all research areas, and are not exclusively linked to case studies or alternative methods of qualitative research. This is further justified by Stoner and Holland (2004: 49), who show the commonality of subjectivity and bias across all research methods.

Irrespective of methodology, it is clear that all research will naturally contain a certain degree of judgement which will need to be applied by the researcher. While one would assume that there is a risk of potential subjectivity and bias within this judgement, Cable (1994: 3) does not find that improper interpretation is a valid risk. Instead, he emphasises that the greatest likelihood of bias is caused by the incorrect application of research methods by the researcher.

In this light, Stoner and Holland (2004:49) suggest that one should place trust in the researcher's judgement as it is likely to translate into value creation. This value is created through the likes of the analysis, key findings and conclusions of the research study.

2.4.3 Validity

Assessing the validity of the case study approach, one can turn to the learning process associated exclusively with this research method. Typically, Flyvbjerg (2006: 5) presents a view that by using context-independent research as the primary means of knowledge accumulation, the learning and development process of students, researchers and professionals stagnate. In this light, graduates typically report that theory and research are unrelated to the problems they face in practise and are generally irrelevant to their overall work roles (Bridges and Hallinger, 2012:2).

Harvard University has recognised this, placing an emphasis on case study learning as an integral part of development for both researchers and lecturers since 1870 (Garvin, 2003). This is because case studies serve three distinctive roles in skills development, while establishing a forum for discussion and debate (Garvin, 2003; Yin, 2013). Case studies help to develop diagnostic skills within the world's fast-paced environment, to develop persuasive arguments, and to think and act in ways that are essential in becoming an effective corporate leader (Garvin, 2003). These points substantiate the validity of case study research in both an academic and industry-related context (see Section 2.3.1), supporting the overall means of justification for the structure of this dissertation.

2.5 Conclusion

This chapter highlights the importance of case study research methodology, proving that researchers, academics and industry professionals will derive broad-based value from exposure to this research method. Taken together, these points of motivation justify the overall structure of this dissertation as a case study, providing a new outlook on real-life IPO events and their associated literature.

Chapter 3: A Critique of Academic Literature - IPO Underpricing Theory and Valuing Unlisted Companies

This chapter aims to address the pertinent issues surrounding IPO underpricing and valuing unlisted companies. It explores the academic literature surrounding these important topics, analyzing the relevant IPO underpricing theories, the valuation methods undertaken to value IPO firms and the effects of accounting data and firm-specific factors when valuing IPO firms.

3.1 IPO Underpricing Theory

3.1.1 IPO Underpricing in the Hong Kong Equity Market

Chan, Wei and Wang (2001) and Qiao (2008) explored IPO underpricing in China and the Hong Kong Stock Exchange.

Using a sample space of 570 A-share[1] IPOs and 39 B-share[2] IPOs in China over the 1993 to 1998 period Chan, Wei and Wang (2001) investigated how institutional factors in the Chinese equity markets affected IPO underpricing. Their study found that the level of A-share IPO underpricing is positively related to the number of days between the IPO share offering and the actual listing date. Furthermore, they also observed an inverse relationship between A-share underpricing and the number of offer shares made available by the issuing firm. Interestingly, the

[1] A-shares are shares in mainland China-based companies that are only available to mainland Chinese citizens. These shares trade on the Shanghai Stock Exchange and Shenzhen Stock Exchange only.
[2] B-shares are shares in mainland China-based companies that can be purchased by foreign investors. Foreign investors can only purchase these
[2] B-shares are shares in mainland China-based companies that can be purchased by foreign investors. Foreign investors can only purchase these shares by adhering to currency regulations. Shanghai B-shares can only be purchased for US dollar denominations while Shenzhen B-shares can only be purchased in Hong Kong dollar denominations. These shares are only available on the Shanghai Stock Exchange and Shenzhen Stock Exchange respectively.

study concluded that there is a direct positive relationship between underpricing and the number of investors originating from the location of the Chinese IPO company.

Qiao (2008) specifically explored the Hong Kong equity market to analyze the time series properties of underpriced IPO shares and the associated initial sales volumes. The study used data from IPOs on the Hong Kong Stock Exchange between November 1999 and December 2005. Qiao (2008) found that in the Hong Kong equity market, IPO underpricing is directly influenced by the level of underpricing undertaken by previous IPOs within industry. In contrast to the findings of Chan, Wei and Wang (2001); Qiao (2008) revealed that there is a direct positive relationship between underpricing and the level of IPO shares offered in the Hong Kong equity market. This notion was supported by a further finding suggesting that the occurrence of industry IPOs is clustered. In light of this, to remain competitive, each IPO firm will intentionally underprice its offer shares in order to promote demand and meet the intended levels of raised capital required.

3.1.2 Asymmetric Information Theory: The Winner's Curse

Studies by Rock (1986), Allen and Faulhaber (1989), Grinblatt and Hwang (1989) and Ljungqvist (2004) suggested that new share issues are underpriced in order to guarantee that uninformed investors participate in the purchase of offer shares.

Rock (1986) termed this theory 'The Winner's Curse', whereby asymmetric information ensures that informed investors will bid on attractively priced IPOs. This means that uninformed investors will not receive an allocation of attractively priced IPO offer shares, and will be left to bid on unattractively priced IPOs. Rock (1986) found that the 'Winner's Curse' is exacerbated by an oversubscription of offer shares prior to the listing date. Demand from informed investors will ensure effective rationing of IPO shares, causing uninformed investors to adjust their valuation of new shares downwards. This encourages uninformed investors to withhold participation in the bid for offer shares until such a time that the offer price has fallen to compensate for the allocation bias towards informed investors.

Should these uninformed investors continue to yield negative returns over time, then markets will fail to continue functioning smoothly. This is because there are not enough informed investors to account for all IPO offer shares available within the market. Thus, accounting for exchange regulations and limit restrictions, the issuing firm needs to ensure that it keeps the best interests of its uninformed investors in mind. If not, this would mean that the equity issue would fail to generate the intended level of funding, and would contradict the intended capital structure goals of the firm.

By exploring general IPO markets in the 1980's, Rock (1986) found that some investors are better informed about the true value of IPO offer shares than both investment banks and the issuing firm itself. This is based on the premise that the knowledge of all market agents combined exceeds the expertise of the firm itself and its investment bank. Thus, the more uncertainty surrounding the true offer price of IPO shares the more advantageous it is for informed investors. This inferred that the issuing firm would have to compensate for this by attractively pricing these offer shares at a deep discount to encourage participation from typically uninformed investors.

Contrary to Rock's (1986) 'Winner's Curse' theory on adverse selection, Vong (n.d.) showed that the adverse selection theory is insufficient to explain IPO underpricing in the Hong Kong equity market. This is because of the new IPO share allocation regulations implemented by the Securities and Futures Commission in Hong Kong (SEHK) which ensure a more favorable allocation of IPO shares to smaller investor pools. What this means is that a clawback provision will mandate a transfer of offer shares to the public tranche of an IPO if the overall demand for the IPO is high. As such, the public investment tranche is increased and a greater number of uninformed investors will have the opportunity to purchase shares in the IPO.

By analyzing 324 Hong Kong-based IPO companies listed on the HKEx over the 2002 to 2007 period, Vong (n.d.) found that as a result of the SEHK clawback provision smaller investors hold a larger level of initial excess returns from Hong Kong IPOs. The clawback provision leads uninformed investors to signal their private knowledge surrounding the IPO through their level of demand for the offer shares. Vong (n.d.) stated that this helps IPO companies to effectively

price their offer shares and reduces the overall level of IPO underpricing. At the same time this ensures a diverse allocation of offer shares which will improve the quality of the aftermarket.

3.1.3 Asymmetric Information Theory: Underpricing as a Signal of Firm Quality

The origins of IPO signaling theory stem from Ibbotson (1975). He studied risk and performance associated with US IPO stocks over the period 1960 to 1969. While this study aimed to measure initial share price performance from the offering date until the day it went public, a secondary objective was to test for departures from market efficiency. Ibbotson (1975) suggested possible reasons for this IPO underpricing; namely that deliberate IPO underpricing would 'leave a good taste in investors' mouths'. Ibbotson (1975) believed that this would encourage attractively priced shares upon a future equity issue. However, he further established that this was in clear violation of the efficient market framework.

Over time additional IPO underpricing theories from Allen and Faulhaber (1989), Grinblatt and Hwang (1989), Denning, Ferris and Wolfe (1992) and Welch (1996), amongst others, have been structured around this signaling concept.

Allen and Faulhaber (1989) considered risk-neutral IPO's within a generalized market to infer their theory. In agreement with Ibbotson (1975), Allen and Faulhaber (1989) stated that a good firm will purposely underprice their offer shares to signal superior prospects in the future. Ljungqvist (2004) agreed with this premise, as good firms will be able to 'suffer' the loss upfront and recoup it later, with the contrary being applicable to bad firms. However, in reaching this conclusion Allen and Faulhaber (1989) had assumed that the IPO firm holds superior knowledge to that of the total agents within the market.

Grinblatt and Hwang (1989) developed a two-parameter signaling model consistent with Ibbotson (1975) to explain new issue underpricing. This generalized model was based on a three-date world and did not focus on a specific exchange. This study drew on the same conclusion as Ljungqvist (2004) and is consistent with the theory behind Allen and Faulhaber's (1989) model. Therefore, by leaving money on the table the issuing firm is directly signaling firm quality. Furthermore, both Grinblatt and Hwang (1989) and Ljungqvist (2004) suggested that by

involving reputable investment bankers, underwriters, auditors and venture capitalists this will also signal a firm's quality.

Denning, Ferris and Wolfe (1992) examined the signaling nature of IPO underpricing using a sample of all US-listed IPOs up until 1985 and their activities ending 1988. Using levels of owner retention, existence of debt and underwriter prestige to determine expected firm quality Denning, Ferris and Wolfe (1992) showed that there is a strong relationship between IPO underpricing and seasoned equity offerings (SEO).They also found that strong levels of underpricing do not translate into greater earnings per share (EPS) for the IPO firm. These overall findings were consistent with Allen and Faulhaber (1989) showing that underpricing can be used as an effective means to signal firm quality.

Welch (1996) presented an IPO signaling model addressing the relationship between firm quality, underpricing and seasoned equity offerings (SEO). The model aimed to demonstrate that signaling of a firm's quality is influenced by more than solely the occurrence of IPO underpricing. Hence, Welch (1996) highlighted shortcomings in Allen and Faulhaber's (1989) model which assumed that a firm's quality is only established directly after the IPO. Therefore, Welch (1996) incorporated the possibility and overall effects of an SEO and other endogenous events on an IPO firm's quality in the near future. Welch's (1996) findings showed that high-quality firms wait longer before undertaking an SEO, while firms will experience higher after-market returns the sooner that they launch an SEO.

Ljungqvist (2004) drew on the trend in key findings between these studies, arguing that they do not contradict each other. Instead, Ljungqvist (2004) found that the commonality between these signaling models is pertinent to a company's listing.

3.1.4 Institutional Theory: Price Support

This theory, also known as price stabilization, as described by Ljungqvist (2004), is a non-deliberate occurrence of underpricing acted upon by underwriters. Should the issuing firm's share price fall below expectations, underwriters of the IPO firm will act to stabilize the price of the offer shares for a period after the IPO market activity. Essentially these underwriters are

naturally incentivized to raise the offer price as this will translate into higher commissions earned.

The origins of price stabilization lay in Ruud's (1993) statistical interpretation to disprove that IPO underpricing is deliberate. Ruud (1993) used data from the Standard & Poor's Daily Stock Price Records for the American Stock Exchange, New York Stock Exchange and Over-the-Counter stocks (OTC) to analyze 463 US IPOs over the 1982 to 1983 period. From this data Ruud (1993) made a key finding that while IPO shares are priced at expected market values, underwriter price support/stabilization may be required to prevent stock prices from falling below the original offer price. Hence, this significantly alters the distribution of initial IPO stock returns, whereby stock prices are allowed to rise (hence no stabilization) but are prevented from falling until all respective offer shares had been sold.

Chowdhry and Nanda (1996) formalize the trade-off between underpricing and after-market price stabilization. They found that stabilization is superior to underpricing when compensating uninformed investors for the effects of 'The Winner's Curse' as theorized by Rock (1986). Through the use of mathematical modeling Chowdhry and Nanda (1996) acknowledged the premise supporting price stabilization in agreement with Ruud (1993). Hence, they showed that deliberate underpricing benefits both informed and uninformed investors, while price stabilization only aids the latter. This mitigates 'The Winner's Curse' altogether.

Furthermore, Chowdhry and Nanda (1996) concluded that the stabilization process should only be undertaken by large reputable investment banks. This is because stabilization is based on actual results and not forecasts. Therefore, an investment bank's access to extensive funding and its ability to weather losses ensure that there is credibility in the stabilization process. Additionally, they also believed that it is a natural occurrence for larger offerings to experience greater amounts of IPO underpricing in general. This is because the loss capacities of IPO firms are not proportional to the size of the offering. Therefore, because the cost of increasing this loss capacity rises extensively with the size of the offering, the IPO firm purposefully lowers its offer price to compensate for a shorter stabilization period.

Asquith, Jones and Kieschnick (1996) supported the conclusions of Chowdhry and Nanda (1996) and found that the cross-sectional distribution of early IPO returns are representative of both price stabilization and underpricing when a mixture distribution is used to represent the cross-sectional distribution of early IPO returns. These key findings refute earlier IPO underpricing theories which suggested that IPO returns are drawn from a common distribution. Thus the study proved that a mixture of two normal distributions more accurately represents the cross-sectional distribution of early IPO returns.

3.1.5 Ownership & Control Theories of IPO Underpricing

When a private company launches its IPO it is essentially separating ownership and control of the company. By allowing public investors to invest in the company this creates a potential agency problem between the IPO firm's management team and these public shareholders. This being because there is a conflict of interest between management's business decisions and the shareholders wanting management to make decisions that will maximize company value. As a result, IPO companies artificially underprice their shares to address ownership and control issues. This can be to avoid or encourage monitoring from public shareholders.

Booth and Chua (1996) explored why ownership dispersion encourages IPO underpricing and the consequential oversubscription of offer shares. They believed that by underpricing the offer shares this encourages excess demand and oversubscription of IPO shares. In turn, the end result is that this achieves a liquid secondary market for these shares. The impact of Booth and Chua's (1996) findings is that the underpricing will cause a rise in information costs for the investor and promotes higher equilibrium underpricing overall. However, the benefit to the IPO firm is that the oversubscription and creation of a liquid secondary market will ensure that maximum proceeds are generated from the IPO.

3.1.5.1 Underpricing as a Means to Retain Control

Brennan and Franks (1997) explored data from 69 UK-based IPOs. This study found that artificial underpricing not only ensures an oversubscription of IPO shares, but also a rationing of

these shares. This allows the IPO firm to discriminate against share applicants and ensures complete managerial control by avoiding monitoring from outside parties.

A key finding of Brennan and Franks (1997) suggested that IPO firms act upon purposeful shareholder discrimination to encourage a greater amount of smaller share applicants. The pair has termed this the 'Reduced Monitoring Hypothesis', as doing so reduces the amount of scrutiny placed on the IPO firm's management team. In addition, Brennan and Franks (1997) also confirmed that the intentions surrounding a reduction of IPO monitoring can be linked to the issuing firm only wanting to target investors which will prove to be complimentary to its future acquisitions.

Ljungqvist (2004) argued that there is an intuitive flaw in Brennan and Franks's (1997) 'Reduced Monitoring Hypothesis'. Ljungqvist (2004) stated that management should rather seek to minimize their level of internal managerial control of the firm. This is because the artificial underpricing actually generates agency costs for the firm in the form of lower IPO proceeds and a lower market value for their shares. This implied that unless the private benefits incurred from using underpricing as a means to retain control outweigh the inherent agency costs of not underpricing the offer shares, then it is counterintuitive for the IPO firm to underprice its offer shares based on this premise.

3.1.5.2 Underpricing as a Means to Reduce Agency Costs

Contrary to Brennan and Franks (1997), Stoughton and Zechner (1998) explored the effects of IPO mechanisms, share ownership structure and the consequential role of both underpricing and rationing in determining the spread of IPO investors. They used an adjusted financial model based on the model undertaken by Admati, Pfleiderer and Zechner (1994) to explore how IPO underpricing can be used to reduce agency costs and enhance the overall value of the IPO firm. Consequently, a key finding of Stoughton and Zechner (1998) stated that an IPO firm's investment banker will intentionally aim to optimally allot the offer shares in favor of large institutional investors. This will ensure greater monitoring of the firm's business decisions and management methods which will eliminate agency costs and are likely to be value-enhancing.

Ljungqvist (2004) argued that regardless of Stoughton and Zechner's (1998) reasons for underpricing an IPO firm's offer shares, an absence of effective monitoring from shareholders will essentially increase the IPO firm's agency costs. This means that regardless, the IPO firm will need to underprice its shares to compensate investors for higher agency costs. This is because there will be uncertainty surrounding management's actions in creating and sustaining shareholder value.

3.2 Valuing Unlisted Companies

3.2.1 Valuation Methods Undertaken to Value IPO Firms

Testing the reliability of the DCF model in estimating the market value of a firm, Kaplan and Ruback (1995) compared the market value of highly leveraged transactions (HLTs) to valuations derived from applying the DCF model.

Using a data sample of 51 HLTs from the 1983 to 1989 period, Kaplan and Ruback (1995) found that the DCF model performs on par with the relative valuation approach. Based on their results, the median estimates of the DCF model were within 10% of the market value of the data sample. However, Kaplan and Ruback (1995) also found that the relative valuation approach adds explanatory power to the DCF model. The impact of these findings led them to recommend that a combination of both models should be used to achieve the best overall estimation of a firm's intrinsic value.

Berkman, Bradbury and Ferguson (2000) compared the accuracy of the DCF and the relative valuation methods in valuing IPO firms. This study explored the application of these valuation models in the thinly traded New Zealand equity market, using data from forty-five IPO firms over the 1989 to 1995 period. In doing so, Berkman, Bradbury and Ferguson (2000) performed these valuations without accounting for firm-specific factors such as industry competitors or the risk and growth prospects of the IPO firm. This was partially because the study was limited to a thinly traded market, preventing them from finding suitable comparable firms.

Berkman, Bradbury and Ferguson (2000) suggested that there were fundamental errors in Kaplan and Ruback's (1995) study. Firstly, they stated that because the operating cash flows of HLTs are stable, there was bias in the study's results. Furthermore, they also revealed that Kaplan and Ruback (1995) limited their DCF model by valuing the firm as a whole and not just valuing the equity component. Most importantly, Berkman, Bradbury and Ferguson (2000) stated that a fundamental error in Kaplan and Ruback's (1995) model was that they calculated the terminal value's cash flows and growth rates independently from each other. This is incorrect because both the cash flows and growth rates associated with the terminal value are dependent on the level of cash flow retention in the terminal year.

By comparing their results to the actual market prices of the IPOs Berkman, Bradbury and Ferguson (2000) showed that both the DCF and relative valuation methods have a median absolute variation of approximately 20%. They also discovered that industry-based valuations generate larger valuation errors, suggesting that market-based valuations are the most accurate measures to value an IPO firm overall. On this notion, they concluded that by choosing a set of comparable firms to estimate betas or earnings multiples in thinly traded markets, these proxy variables can enhance a valuation model overall.

In a similar light to Berkman, Bradbury and Ferguson's (2000) study, Demirakos, Strong and Walker (2004) aimed to determine whether choosing to use the relative valuation model or DCF model affected the forecast accuracy of target prices issued by investment analysts when controlling for influential factors. By analyzing the predictive performance of these valuation models, Demirakos, Strong and Walker (2004) used two measures of target price accuracy and two measures of forecast error to deduce if there were significant differences in the valuation outcomes achieved by both models. By analyzing data from a sample of 490 UK-based equity research reports over the July 2002 to June 2004 period, their findings showed that analysts tend to primarily use the DCF model for smaller firms, high-risk firms, loss-making firms, firms with largely negative or positive sales growth and for firms which have a limited number of industry competitors. Without adjusting for these factors, they found that the relative valuation model outperforms the DCF model. However, after adjusting for these factors the opposite was true.

Continuing the studies of Berkman, Bradbury and Ferguson (2000) as well as Demirakos, Strong and Walker (2004); Gelman (2006) used both a relative valuation and DCF analysis to investigate reasons for IPO underpricing and recreate the pre-IPO valuation process of investment banks. This study aimed to deduce which valuation method would yield the most accurate reflection of an IPO firm's share price one-month after listing. Using a sample of forty-one small cap IPO firms on the US-based Russell 2000 Index for the 2005 year, Gelman (2006) conducted a relative valuation and DCF analysis on both the top two and bottom two performing IPOs within the sample.

Gelman's (2006) findings showed that in terms of the relative valuation, the price-earnings (P/E) multiple provides the best indication of an IPO firm's share price one month after listing. Gelman's (2006) second observation suggested that enterprise value-to-revenue (EV/R) is the second most useful multiple because it is suitable for IPO firms with negative earnings. After applying the DCF model, Gelman (2006) found that the performance of the model is highly dependent on the level of mispricing in the market. Gelman (2006) found that the DCF method significantly overvalues IPO firms when compared to a relative valuation. This was proven by a sensitivity analysis that showed the most accurate results were only achieved when applying the highest discount rate and the lowest EBITDA multiple suitable to each IPO firm.

However, contradictory to her previous findings, Gelman (2006) found that when valuing the two most overpriced IPO shares in the sample, the combined use of the P/E multiple, EV/R multiple and the DCF model significantly improved the overall value placed on these IPO firms.

Gelman's (2006) application of the relative valuation model and DCF model left less money on the table than what actually occurred in the 2005 year. Nonetheless, when valuing the two most accurately priced IPO firms in the sample, the performance of the underwriters could not be matched. This led Gelman (2006) to conclude that underwriters possess private qualitative outside information which causes them to price these IPO firms more accurately than others.

Extending on Demirakos, Strong and Walker (2004) and Gelman's (2006) findings, Roosenboom (2007) incorporated firm-specific factors and aggregate stock market conditions to

investigate how French underwriters valued IPO companies. This study aimed to investigate how underwriters select their IPO valuation methods, how these methods are combined to arrive at a fair value estimate for the IPO and how these underwriters set preliminary offer prices based on these fair value estimates. By reviewing 228 market reports compiled by French underwriters and how they valued IPO stock listings on the Euronext Paris over the 1990 to 1999 period, Roosenboom (2007) found that underwriters typically conducted a multiples analysis to value these IPO firms. This was especially pertinent to technology firms, firms experiencing rapid growth and profitable firms.

However, Roosenboom (2007) found that this changed according to the level of aggregate stock market returns and status of the stock market in general. It was evident that the DCF model and economic value add (EVA) model was frequently used when aggregate stock market returns were high or when the aggregate stock market was relatively volatile. This was because high aggregate market returns provided a window of opportunity for investors to purchase stock, placing greater reliance on the assumptions surrounding the DCF and EVA models. On the other hand, when the aggregate stock market was volatile the DCF and EVA models provided sufficient fundamental information required by investors at that time.

Roosenboom (2007) extended his findings to the dividend discount model (DDM) which was observed to be the preferred valuation method when aggregate market returns were low. The DDM model was also the preferred valuation method used by older firms in mature industries that typically planned to pay out large future dividends.

Contrary to the findings of Demirakos, Strong and Walker (2004) and Roosenboom (2007); Deloof, De Maeseneire and Inghelbrecht (2009) found that the DCF model is the most popularly used valuation tool by investment banks when valuing IPOs. Deloof, De Maeseneire and Inghelbrecht (2009) extended Roosenboom's (2007) study by offering empirical evidence on the accuracy and bias of the implemented valuation methods. By analyzing 49 IPOs on the Euronext Brussels exchange over the 1993 to 2001 period, they investigated the valuation and pricing methods undertaken by investment banks when valuing IPOs.

They found that the DCF model achieves an unbiased estimate of the IPO firm's intrinsic value when compared to other valuation methods. This was while the DCF, DDM and relative valuation methods all yielded similar accuracy levels when they were used to value the same IPO firm. This means that the DCF model is on an equal par with relative valuation models when valuing IPO firms. Deloof, De Maeseneire and Inghelbrecht (2009) predominantly attributed the higher adoption rate of the DCF model to to the lack of comparable competitors for IPO firms. They believed that this incentivizes investment banks to place greater importance on the DCF model and to pursue this model as an alternative valuation tool to a multiples analysis. Additionally Deloof, De Maeseneire and Inghelbrecht (2009) also found that the quality and objectives of the IPO firm's prospectus play a contributing factor in the valuation method undertaken by investment banks.

3.2.2 The Effect of Accounting Data and Firm-Specific Factors when Valuing IPO Firms

Kim and Ritter (1998) challenged the widely recommended notion that accounting information must be used in conjunction with comparable firm multiples to value IPOs. This study questioned the usefulness of the approach, claiming that it was standard practice in both an academic and industry context.

Using a data sample of 190 domestic IPOs over the 1992 to 1993 period, Kim and Ritter (1998) priced these IPOs by comparing them to firms with comparable operating and financial performance history. In doing so, it was evident that the multiples of comparable firms were typically higher than the IPO firm. This was because of the contrasted use of market prices for comparable firms and offer prices for the IPO firm.

Based on the results of their findings, Kim and Ritter (1998) deduced that historical data has an intrinsic limitation when valuing an IPO firm by comparing the price-to-earnings (P/E), price-to-sales (P/S), enterprise value-to-sales (EV/S) and enterprise value-to-operating cash flow (EV/CF) multiples. Their reason for this was because historical accounting data does not necessarily reflect the IPO firm's future performance. As a result, Kim and Ritter (1998) recommended that using earnings forecasts will considerably improve the overall accuracy of the valuation.

This finding was supported by Deloof, De Maeseneire and Inghelbrecht's (2009) whereby they too concluded that the P/E and P/CF multiples will yield a more accurate result if one uses one-year forecasted estimates in their model as opposed to using accounting data of the IPO firm. However, the discrepancies between Kim and Ritter (1998) and Deloof, De Maeseneire and Inghelbrecht's (2009) models are that Kim and Ritter (1998) used actual academic estimates to support their findings whereas Deloof, De Maeseneire and Inghelbrecht (2009) used real industry estimations. Furthermore, Kim and Ritter (1998) generically applied the same valuation multiples across all industries. This meant that there was potential bias in their study as some industries would have placed greater emphasis on specific variables more so than others.

Kim and Ritter (1998) also found that one should place great importance in adjusting for different profitability and growth factors between the comparable firm and the IPO firm. This is because these factors account for the specific attributes of the IPO firm, preventing relevant information from being ignored.

Juxtaposed to Kim and Ritter (1998) and Deloof, De Maeseneire and Inghelbrecht's (2009) findings; Beatty, Riffe and Thompson (2000) found that by combining accounting data with market characteristics this explains approximately 80% of IPO offer prices. This was specifically in relation to accounting book value, revenue and earnings. By conducting a regression analysis on 2,577 US IPO firms, Beatty, Riffe and Thompson (2000) found that the explanatory power of their model was highly dependent on the design and form of the model. Accompanied by this, they also found that by incorporating economic factors such as the percentage ownership retained, market conditions and time factors this significantly increased the explanatory power of the model.

Beatty, Riffe and Thompson (2000) extended their research to investigate the role of accounting information in determining the average filing price in the preliminary IPO prospectus. Furthermore, they explored the interrelationship between incorporating accounting data into the filing and offer prices of an IPO firm and how this affected first day stock returns. In this context Beatty, Riffe and Thompson (2000) found that contrary to their expectations, accounting information plays a more prominent role in determining an IPO company's filing price and not

the offer price. This means that when determining the filing price of its stock, IPO underwriters consider all accounting information and not just certain variables. Therefore, as per Gelman (2006) when determining the final IPO offer price all adjustments made by underwriters will encompass other private qualitative data.

To test the effect of these findings on the first day stock returns of IPO firms Beatty, Riffe and Thompson (2000) found that by using the standard deviation of IPO returns as a proxy for risk; earnings, book value and revenues were strongly negatively correlated. They also found that after adjusting for risk, market conditions and other residuals the IPO firm's earnings and book value assisted in explaining the first day IPO stock returns. This finding inferred that as an investor, accounting information is not actually fully considered when determining the offer price of an IPO company.

Addressing Deloof, De Maeseneire and Inghelbrecht's (2009) comments surrounding a lack of comparable competitors for IPO firms, Bhojraj and Lee (2002) developed a systematic approach in selecting suitable comparable firms when valuing unlisted companies.

While Bhojraj and Lee (2002) recognized that relative valuations are cost-effective and time-efficient, they also recognized that valuation multiples fail to capture firm-specific information when choosing a suitable comparable firm. In response, they developed 'warranted multiples' for each firm, compensating for information loss within these variables by incorporating the effects of cross-sectional variations in a firm's growth, profitability and risk characteristics. This allowed for the IPO company's potential comparable firms to be ranked in accordance to the overall similarities between the two companies. Furthermore, it provided a more objective method to identify comparable companies.

By forecasting the enterprise value-to-sales (EVS) and price-to-book (P/B) multiple of comparable firms for a one to three-year period ahead, Bhojraj and Lee (2002) found that the warranted multiples approach significantly improves the outcomes of the traditional relative valuation model. This was especially prominent amongst stocks in the technology, biotechnology and telecommunication industries. As key findings of this study, Bhojraj and Lee (2002) found that the effectiveness of the warranted multiples approach was most prominent when valuing

private and IPO firms. In support of Kim and Ritter (1998) and Beatty, Riffe and Thompson (2000) they also found that an industry-based approach with firm-specific adjustments is most effective in capturing the true essence of valuation theory. Furthermore, while it is not possible to use historical 'lagged' multiples for private and IPO firms, Bhojraj and Lee (2002) found that a company's own lagged multiples yield the greatest amount of explanatory power for the value of its current multiples.

In the same manner, Koop and Li (2001) analyzed and assessed the potential roles of explanatory variables when valuing an IPO firm. To do this, they examined the pricing of IPO and seasoned equity offerings (SEO) firms using a stochastic frontier model. This ensured that Koop and Li (2001) could effectively capture mispricing in the market by modeling the differences between both the maximum possible value of the IPO firm and the actual value at the time of the offering as a function of observable firm characteristics. Based on a data sample of 2,969 IPO firms and 3,771 SEO firms between 1985 and 1998, Koop and Li (2001) found that the market capitalization of IPO and SEO firms was positively related to net income, revenue, total assets and underwriter fees. The opposite was true in relation to debt levels. They also found that in the computer, communications, electronic equipment, scientific instrument and chemical product industries that firms with higher earnings potential had naturally higher valuations overall.

Supporting the findings of Kim and Ritter (1998), Beatty, Riffe and Thompson (2000) and Bhojraj and Lee (2002); Koop and Li (2001) showed that accounting data such as profitability, the level of firm operations and company risk have large explanatory power when valuing IPO firms. They also established that underwriter reputation and windows of opportunity are not significant explanatory variables when valuing IPO and SEO firms.

Bhagat and Rangan (2004) expanded on prior academic literature, examining the effects of income, sales, book equity, growth opportunities, insider retention and investment banker prestige on IPO firm value. In doing so, they apportioned a sample of 1,655 IPOs into three respective time periods.

In an effort to determine data trends in IPO valuation methodologies prior to the Dotcom bubble, during its boom period and during the Dotcom crash; Bhagat and Rangan (2004) analyzed the periods dating 1986 to 1990, January 1997 to March 2000 and April 2000 to December 2001.

A key finding of Bhagat and Rangan ‘s (2004) research showed that when they applied a set of IPO fundamentals to the various time periods under review, there was no statistical difference in their results. The only major difference between the time periods was that the influence of the income and sales variables changed according to the status of the markets. This was observed during the January 1997 to March 2000 boom period when results showed that a greater weighting was placed on income over sales when compared to the 1986 to 1990 period.

Interpreting their results further, Bhagat and Rangan (2004) also found that by controlling these variables technology companies actually received a lower valuation than non-technology firms. This was while technology firms placed a greater weighting on income and insider retention. Contrastingly, when Bhagat and Rangan (2004) categorized these technology firms into internet and non-internet firms they found that there was no actual valuation difference between the two classes. However, here internet firms placed greater weighting on insider retention and investment banker prestige when compared with non-internet firms.

It is clear that there are numerous theories supporting the rationale behind IPO underpricing in the market. It was revealed that there are unique underpricing trends in the Hong Kong equity market, while the SEHK IPO share allocation regulations nullify the effects of the ‘Winner’s Curse’ asymmetric information theory in the Hong Kong market altogether. It was further suggested that within different markets analysts are inclined to favor using the DCF model, relative valuation model or a combination of both when valuing IPO firms. This choice is influenced by firm-specific and accounting data inputs that significantly affect the accuracy of these valuation models. These topics are explored throughout the remainder of this case study.

3.3 Relevance of Academic Literature to the Tencent IPO Case

3.3.1 IPO Underpricing Theories

By highlighting the extensive theories of IPO underpricing, Section 3.1 proves that there are many potential means to which IPO underpricing may occur. Keeping in mind that while all IPO firms may not leave money on the table, the Tencent IPO effectively presents a compelling case to test these theories by applying them to a real-life IPO event. The uniqueness of the Tencent IPO over other IPO cases is not only its historical significance. Instead, it is the contextual background of Tencent's IPO, as a rising internet and telecommunications value-added service provider pre, during and post the Dotcom Bubble within the Chinese and Hong Kong financial markets.

This context creates value in the case as it explores common IPO underpricing theories and tests the suitability of these theories to IPOs in China and Hong Kong. Section 3.1.1 shows that while asymmetric information theories, institutional theories as well as ownership and control theories of IPO underpricing are tested in Western IPO markets, there is little application to Asian markets (see Section 3.1.3, 3.1.4 and 3.1.5). Furthermore Chan, Wei and Wang (2001), Qiao (2008) and Vong (n.d.) have theorised the cause and effects of IPO underpricing in China and Hong Kong (see Section 3.1.1 and 3.1.2). This case study allows one to test these theories for similarities or differences when applied to the Tencent IPO.

The structure of the case (see Section 1.2) ensures that this theoretical framework surrounding IPO underpricing is coherently explored. As such, the holistic nature of the case establishes the ability to interpret and modify existing theories on IPO underpricing, and to compliment and create new IPO underpricing theory.

It ensures that one is able to assess the Tencent IPO in the same nature as Chan, Wei and Wang (2001) to investigate contributory underpricing factors in Chinese equity markets; Qiao (2008) in finding that a direct positive relationship exists between underpricing and number of shares on offer, that IPOs in the Hong Kong equity market are influenced by previous levels of

underpricing and are typically clustered; and Vong (n.d.) who, aside from finding evidence of underpricing, discovered that HKEx regulations ensure equal distribution of IPO offer shares in this market.

In this same way the practical assessment characteristics of the Tencent IPO case allows for one to explore the more commonly accepted IPO underpricing theories of Rock's (1986) 'Winner's Curse', Ibbotson's (1975) signalling theory of IPO underpricing, Ruud's (1993) theory of price stabilization and ownership and control theories explored by Booth and Chua (1996), Brennan and Franks (1997) and Stoughton and Zechner (1998).

The same applies to the theoretical findings that supplement this existing theoretical framework. These include Allen and Faulhaber (1989), Grinblatt and Hwang (1989), Denning, Ferris and Wolfe (1992), Welch (1996), Chowdhry and Nanda (1996), Asquith, Jones and Kieschnick (1996) and Ljungqvist (2004).

3.3.2 Valuing Unlisted Companies

Academic literature shows that the valuation methods undertaken to value an IPO firm is a contentious issue in finance. As per Section 3.2.1, academic literature theorises around the choice between the discounted cash flow (DCF) and the relative valuation as the most appropriate means to valuing an IPO firm. Section 3.2.2 compliments these theories, in which additional academic literature theorises around the importance of accounting data and firm-specific factors when undertaking an IPO valuation.

3. 3.2.1 Valuation Methods Undertaken to Value IPO Firms

The origin of this debate lies in the true essence of what an IPO represents – the first time a company offers its stock via a public exchange. Taking this into account, an IPO firm's lack of public market exposure creates inherent challenges when trying to assess the value of the IPO firm before it goes public.

This case study has been structured with the approach to ensure that these valuation theories are directly tested. By constructing a case around Tencent, this level of rich insight and detailed information provides an effective platform for one to directly assess the validity of these valuation theories within the context of the Tencent IPO.

Consequently, Chapter 6 illustrates the implementation of these valuation methodologies in achieving an overall price for Tencent's offer shares.

This case study therefore directly explores the valuation theories of Kaplan and Ruback (1995), Berkman, Bradbury and Ferguson (2000), Demirakos, Strong and Walker (2004), Gelman (2006), Roosenboom (2007) and Deloof, De Maeseneire and Inghelbrecht (2009).

In exploring this theoretical framework, the case addresses the various findings of the respective literature through the combined use of both the relative valuation and discounted cash flow (DCF) valuation methodologies (see Section 1.2.5). This is because while some valuation theories suggest both methodologies yield consistent results, others favor the relative valuation and vice-versa. This was particularly relevant in Demirakos, Strong and Walker's (2004) finding that the outperformance of the DCF model versus the relative valuation model was highly dependent on whether firm-specific factors were accounted for.

As put forth by Deloof, De Maeseneire and Inghelbrecht (2009), investment banks typically favored the DCF model when valuing IPO firms. However, in order to ensure the correct application of the DCF valuation method, certain valuation data is required. Considering Tencent was an IPO firm lacking market exposure, the best approach to ensuring a cohesive and insightful valuation was to incorporate a relative valuation into Chapter 6. This approach was further supported by Gelman's (2007) theory that the relative valuation forms a complimentary relationship with the DCF model.

In doing so, this draws on Berkman, Bradbury and Ferguson's (2000) study emphasising the advantages of proxy variables in enhancing a valuation model. In determining a method to find suitable proxy variables, the case uses Roosenboom's (2007) findings as stimulus to pursue a

multiples analysis. This being because Tencent met all three of Roosenboom's (2007) conditions as a technology firm, a profitable firm or a firm experiencing rapid growth.

At the same time, this approach tested the accuracy of DCF and relative valuation models, testing the theories imposed by Kaplan and Ruback (1995) and Deloof, De Maeseneire and Inghelbrecht (2009) that the performance of these models were on par; while Berkman, Bradbury and Ferguson (2000) disagreed.

3. 3.2.2 Accounting Data and Firm-Specific Factors

Theories surrounding accounting data and firm-specific factors when valuing IPO firms are explored extensively throughout this case study. Taking into account the nature of the case study research method (see Chapter 2) combined with the points illustrated in section 3.3.2.1 above, it is clear that Tencent's accounting data and firm-specific factors are thoroughly considered and applied throughout the case.

This is particularly relevant in terms of the complex valuation undertaken in Chapter 6. Herewith the theories of Kim and Ritter (1998), Deloof, De Maeseneire and Inghelbrecht (2009), Beatty, Riffe and Thompson (2000), Bhojraj and Lee (2002), Koop and Li (2001) and Bhagat and Rangan (2004) provide a theoretical framework throughout this chapter.

As theorised by of Bhojraj and Lee (2002), Section 6.1 ranks Tencent's potential comparable firms according to similarities in growth, profitability and risk characteristics (this is summarised in Table 6.7 of Section 6.1.8). This objective assessment method was further supported by Kim and Ritter (1998), Beatty, Riffe and Thompson (2000) and Koop and Li (2001) because this firm-specific information and accounting data has large explanatory power. This explanatory power enhances the effectiveness of the relative valuation model.

Section 6.2 builds on this approach, accounting for the suitability of certain valuation multiples in the context of Tencent's IPO. This section specifically adjusts for differences in probability and growth factors of Tencent's most comparable firm, as suggested by Kim and Ritter (1998). This proxy firm's multiples are used to calculate Tencent's offer price range.

3.4 Conclusion

It is clear that there are numerous academic theories surrounding IPO underpricing, valuing an IPO and the effects of accounting data and firm-specific factors when valuing IPOs. This establishes a theoretical framework on which this dissertation is based. All of these topics of relevancy are consistently explored throughout by applying them to the real-life contextual case.

As such, this dissertation has been structured to compliment and contribute to this theoretical framework.

Chapter 4: Tencent Holdings Limited - The Case

"When we were a small company, we needed to stand on the shoulders of giants to grow up… but copying others can't make you great. So the key is how to localize a great idea and create domestic innovation." – Ma Huateng,

– CEO and Founder, Tencent Holdings Ltd.[3]

It was 7 June 2004. Tencent Holdings Limited (Tencent) had just received approval, in principal, for an application to the Listing Committee of the Hong Kong Stock Exchange (HKEx). Just less than six years ago, on 11 November 1998, Tencent Computer System Co (Tencent Computer) was founded by Ma Huateng (Pony Ma) with the help of his high school friend Zhang Zhidong, in Shenzhen, Guangdong, People's Republic of China (PRC).

Tencent Computer was a limited liability company founded on 500, 000 RMB of registered capital. This registered capital constituted of 300, 000 RMB (60%) contributed from Ma Huateng's mother, Huang Huiqing, and 200, 000 RMB (40%) from Zhao Yonglin. Subsequent movements in the capital allocation of both Huiqing and Yonglin resulted in five core founders of Tencent Computer: Ma Huateng (47.5%), Zhang Zhidong (20%), Zeng Liqing (12.5%), Xu Chenye (10%) and Chen Yidan (10%).[4] At this time, the five core founders proportionally increased the total registered capital of Tencent Computer to 1, 000,000 RMB.

[3] Wang, X. 2009. *A Mysterious Message Millionaire.* Available: http://www.chinadaily.com.cn/business/2009-01/12/content_7388202.htm [2014, March 24].

[4] Huang Huiqing transferred her 300, 000 RMB contribution to the following shareholders:
Ma Huateng – 112,500 RMB
Zeng Liqing – 62,500 RMB

Zhao Yonglin transferred his 200, 000 RMB contribution to the following shareholders:
Zhang Zidong – 100,000 RMB
Xu Chenye – 50,000 RMB
Chen Yidan – 50,000 RMB

It was not Ma Huateng's initial intention to establish what has commonly come to be known as Tencent. His core vision was to create and develop an instant messaging internet service for the Chinese market that would later be sold off to large corporate companies. After profiting from this venture, Ma Huateng did not foresee future growth potential for the firm itself and aimed to return to his corporate job. Ma approached four companies with his prototype, but none of them had confidence in him or the appeal, longevity and feasibility of the concept. As explained by one venture capitalist, "I called up a friend working in the telecom industry. He said Ma was just junior staff." [5]

Ironically, at the time of showcasing his concept, Ma Huateng approached current industry rival TOM.com as well as his previous employer China Motion. Their rejections would lead to the development of China's leading provider of internet (IVAS) and mobile (MVAS) value-added services and its groundbreaking QQ instant messenger.

4.1 Product and Service Offerings

4.1.1 OICQ (QQ) Instant Messenger

As a small company focusing on value–added software and systems integration services, Tencent first introduced its QQ instant messaging service, QQ99 beta build 0210 in the PRC on 10 February 1999. The initial build of this instant messaging service was marketed as the 'internet pager' or 'buddy list', being the first of its kind in the Eastern market. QQ99 beta build 0210 marked the first time that users were able to concurrently monitor other users' online presence, while communicating with each other in real-time. This earmarked the beginning of a revolutionary development in next generation commercial and personal communication software in Asia.

The original concept for the QQ instant messaging service originated in 1996 from Israeli messaging solutions provider, Mirabilis Ltd (Mirabilis). Four young Israeli college students Yair

[5] Sherman, S. & Westland, C. 2010. *Red Wired: China's Internet Revolution*. Available: http://books.google.co.za/books?id=vbqIAAAAQBAJ&printsec=frontcover&source=gbs_ge_summary_r&cad=0#v=onepage&q&f=false [2014, February 28].

Goldfinger, Arik Vardi, Sefi Vigiser and Amnon Amir developed original software named ICQ (I Seek You).[6] Two years later on 5 June 1998, America Online (AOL) purchased 100% of Mirabilis's assets (ICQ) directly for US$287 million.[7]

Considering the popularity and success of both the ICQ brand and concept in the United States of America and United Kingdom, both Ma Huateng and Zhang Zhidong took it upon themselves to develop a replica instant messaging platform known as OICQ (Open ICQ). After AOL filed a complaint against Tencent, a court ruling in favor of AOL forced Ma Huateng to rebrand OICQ to QQ instant messenger in 1999.[8]

At this time, Ma Huateng approached prospective Chinese investors to invest in Tencent's QQ offering. However, this was to no avail. Resultantly, he released QQ into the Chinese market as a freeware offering. By May 2000 the service achieved a company milestone with 100 000 simultaneous online QQ users (see Appendix A, Exhibit 3).

Tencent continued to solidify its dominance in China's instant messaging marketspace. Over the next four years leading up to the official IPO listing date, Tencent introduced a variety of software updates and value-added services integral to the success of the QQ brand. This led to exponential growth in its QQ user base over this period (see Appendix A, Exhibit 3).

November 2000 saw the official launch of Tencent's QQ2000 instant messaging platform. This version of QQ marked the introduction of e-commerce into the QQ platform by encompassing new features. These features include a web-based browser named Tencent Explorer, a news panel and the ability for one to change their QQ SKIN. The introduction of QQ 2000 solidified Tencent's position in the instant messaging market space even further, which by February 2001 represented approximately 90% of the Chinese instant messaging market space.[9]

[6] Britannica. 2014. *ICQ (Software).* Encyclopedia Britannica.Available: http://www.britannica.com/EBchecked/topic/1472953/ICQ [2014, March 27].
[7] Hansell, S. 1998. *America Online to Buy Internet Chat Service for $287 Million.* The New York Times. Available: http://www.nytimes.com/1998/06/09/business/america-online-to-buy-internet-chat-service-for-287-million.html [2014, March 27].
[8] National Aribtration Forum. 2000. American Online, Inc (Complainant) vs. Tencent Communications Corp (Respondent).Available: http://www.adrforum.com/domains/decisions/93668.htm [2014, March 24].
[9] Tencent. 2001c. *Tencent QQ awarded "Editor's choice" by Personal Computer magazine*. Available: http://www.tencent.com/en-us/at/pr/detail.shtml?id=at_2001_200102 [2014, March 24].

One month later Tencent licensed the exclusive right to develop QQ branded products to Guangzhou Donice. This manufacturing and distribution company specialized in product development and international distribution of garments, souvenirs, toys and other products; ensuring retail exposure of the QQ brand in more than 20 countries.

With added emphasis on existing and new value-added services, Tencent replaced and introduced a newly designed QQ membership card in May 2002. The rationale behind this decision was to encourage and promote users to adopt and purchase these value-added service offerings. To leverage this rollout initiative Tencent reached a cooperation agreement with Beijing Federal Software Co. Ltd. (Federal Software) as the sole agent for the supply of the new Tencent QQ card in China. Federal Software's market dominance and experience in software product marketing ensured the most effective means of availability for Chinese consumers.

In an effort to build on its reputation Tencent introduced Tencent Messenger (TM) in December 2003. The rationale behind Tencent Messenger was to provide a platform for internet users to communicate online with friends under an office environment. This platform deemphasized entertainment and recreation, focusing on QQ's primary software features and adapting them to be directly suitable and complimentary to a business environment.

In the year of its IPO, Tencent released two updated versions of the QQ instant messenger platform, QQ2003III and QQ2004. While QQ2003III saw minor updates and changes to the platform, eight days prior to the IPO listing date Tencent released QQ2004 as a final push at the instant messaging market before going public.

QQ2004 revolutionized Tencent's internet value-added service (IVAS) offerings, setting precedent for both local and international instant messaging (IM) competitors. With a focus on user experience QQ2004 emphasized usability, simplicity and practicality in its operative capacity. This updated version enhanced the QQ user experience by focusing on Tencent's avatar, browser, email, music, network sharing, online gaming and its RTX enterprise IM software.[10]

[10] Tencent. 2004c. *Interim Results: 2004.* Available: http://www.tencent.com/en-us/content/ir/rp/2004/attachments/200401.pdf [2014, July 22].

4.1.2 Mobile Value-Added Services (MVAS)

In April 1999 Tencent unveiled its mobile email service. An effective, fully operable email client allowed mobile users to fully access and operate their email accounts on their phones for the first time. This service enabled mobile phone users to send/receive emails and communicate with internet users via SMS, while also acting as an electronic notepad and e-dictionary between English and Chinese.[11]

The launch of this service marked the beginning of a long-lasting partnership between Tencent and the Shenzhen division of Chinese mobile provider China Unicom (Shenzhen Unicom). In keeping up to date with industry changes, Tencent acted on this newly formed business relationship through the release of TIMS 2.0. TIMS 2.0 supported the change from pagers to mobile handsets through the release of the STK 2nd generation SIM card. TIMS 2.0 enabled a QQ-GSM two-way communication for mobile phone users, making it possible for mobile phone users to send/receive calls off their mobile devices.[12]

As the Chinese pager market began to decline, Tencent and Shenzhen Unicom capitalized on the mobile phone market. This saw the introduction of Tencent's new mobile communications service Mobile QQ on International Telecom Day. As of 17 May 2000 Mobile QQ enabled mobile phone users to communicate with PC-based QQ users via Short Message Service (SMS) text messaging.

By keeping up with this technological progression, Tencent's MVAS division became the company's primary revenue contributor. This collective effort also saw Tencent and China Unicom derive synergistic value from Mobile QQ. Herewith Tencent was the largest instant communications service provider in Asia with more than 10 million users. This was while China Unicom was regarded as the second largest telecom enterprise in the PRC, with more than 10 million users in the PRC and more than 300,000 in Shenzhen alone.

[11] Tencent. 2001a. *Tencent launched email value-added service system in cooperation with SINET*.Available: http://www.tencent.com/en-us/at/pr/detail.shtml?id=at_2001_199907 [2014, March 24].
[12] Tencent. 2001a. *Tencent launched mobile email service in cooperation with Shenzhen Unicom.*Available: http://www.tencent.com/en-us/at/pr/detail.shtml?id=at_2001_199904 [2014, March 24].

By April 2001 Mobile QQ was licensed to almost twenty mobile operators, including Beijing Mobile, Guangdong Mobile, Guangdong Unicom, Shanghai Mobile, Shanghai Unicom, Shenzhen Unicom and Zhejiang Unicom. During this time QQ featured its latest value-added service, QQ Club. Tencent termed the service to be 'from the cyber users and for the cyber users' boasting a strong selection of resource-consuming services.[13] This included faster speeds, more stable services, greater discounts and more comprehensive functions.

4.1.3 Internet Value-Added Services (IVAS)

In an effort to penetrate into the PC-based market space, Tencent jointly launched its email value-added service system with China's Science Information NETwork (SINET) in July 1999. In partnership with the Shenzhen Telecommunication Bureau (Shenzhen Telecom), both companies jointly implemented the SINET email service solely on a trial-basis. With its core focus on dial-up clients of internet service providers (ISP) this system enabled dial-up users to receive e-mail notifications, set up user-defined rules and show emails via the user's mobile phone, pager or fax machine.[14]

Less than one year later, Tencent continued to build on its momentum in the value-added services market with the official launch of its free email service for existing and new ISPs. While this offering was exclusive to Shenzhen Telecom, it was also limited to a service capacity of five million users. This service capacity was expected to expand exponentially as technological innovation continued to reduce infrastructural costs in the future.

2003 marked the turnaround year for Chinese internet companies since the Dotcom crash. As Tencent continued to grow its user base and enhance its appeal to the Chinese market this period saw growth in areas of online gaming, online advertising and mobile messaging. This industry growth benefitted Tencent's NASDAQ-listed competitors as their share prices increased.

[13] Tencent. 2001b. *Tencent participated in the Beijing Comdex 2001 Exhibition*.Available: http://www.tencent.com/en-us/at/pr/detail.shtml?id=at_2001_20010404 [2014, March 24].
[14] Tencent. 2001a. *Tencent launched email value-added service system in cooperation with SINET.*Available: http://www.tencent.com/en-us/at/pr/detail.shtml?id=at_2001_199907 [2014, March 24].

Considering the recovery and growth of the Chinese internet and telecommunications industry, Tencent continued to design and develop new offerings. This allowed the company to enter into new market spaces and gain market share in untapped established markets.

August 2003 marked Tencent's first attempt at capturing market share in the Massively Multiplayer Online Role-Playing Game (MMORPG) market space. Tencent exclusively created and developed QQ Game, an online trial operation providing solo and multiplayer gaming services. This was followed up by the launch of a test version of its internet entertainment portal website QQ.com in November 2003. While the market itself was highly competitive, a spokesperson for Tencent, Lou Lili, explained that, "Our (Tencent) goal is to become a mainstream internet portal that focuses on entertainment…our customer base and messaging service were already moving in that direction." [15]

In December 2003 Tencent entered the MMORPG marketspace with 'Sephiroth'. This game was licensed from a Korean-based game development company known as Imazic of Korea. Tencent offered its users a choice to pay per hour of gameplay or to pay a monthly fee for unlimited gameplay hours. At that point in time Tencent had established an in-house MMORPG development team to develop its own MMORG games.

QQ Game proved a fruitful venture for Tencent, effectively penetrating the MMORPG market space. Within nine months since its release QQ Game's user base exceeded company expectations reaching a total of 300,000 simultaneous online user accounts in May 2004.[16]

4.1.4 Commercial Enterprise Solutions

In an effort to establish a first-mover competitive advantage in the enterprise IM market, Tencent launched its enterprise IM product 'Tengzuntong' Real Time eXchange (RTX) in Kerry Center, Beijing on 9 September 2003.

[15] China's Tencent take on Nasdaq Internet portals.2003. *China Daily. 31 November.* Available: http://www.chinadaily.com.cn/en/doc/2003-11/21/content_283657.htm [2014, March 21].
[16] Tencent. 2004b. *QQ Game's simultaneous online user accounts broke 300 thousand.* Available: http://www.tencent.com/en-us/at/pr/detail.shtml?id=at_2004_20040514 [2014, March 27].

Tencent was the first company to release software in the enterprise market, providing and creating a new means of effective communication and operation for businesses. Tencent invested 100 million RMB (US$12 million) to market and promote these RTX systems.

While Tencent originally tried to penetrate the enterprise market with BQQ in December 2001, RTX set to redefine security, controllability and efficiency within enterprises. This initiative received support and praise from Tencent's partners: IBM, UFsoft, Kingdee, Hi-Tech Wealth, ChinaSuntek and Kingsoft. Furthermore, research from a leading third-party consultancy firm at the time suggested that RTX could improve employee efficiency by 17% and save a business a total of approximately 13% on telephone bills.[17]

To build on this competitive advantage, Tencent and IBM jointly signed a contract in Beijing China to officially declare a strategic cooperation between the two companies in the future. This agreement ensured joint entry into the Enterprise Instant Messaging (EIM) market, with Tencent leveraging its RTX offerings by integrating IBM's QuickPlace software. This saw Tencent expand its target market to medium and large enterprises and marked a significant step in the accelerated development of e-commerce in China.

By the end of March 2004 Tencent's RTX division had over 90,000 registered users including Coca Cola, China Sinopec, Chery Automobile, AMT, TCL and Xinjiang Mobile.[18]

4.2 Venture Capitalists & Foreign Investors

Tencent realized exponential growth of 900% in its user base from 1 million in December 1999 to 10 million by June 2000, but QQ infrastructural running costs eroded profitability. Tencent continued to operate at a loss in the year 2000 and this became a large concern for Ma Huateng.

[17] Tencent. 2003. *RTX is launched as the Real-Time-Enterprise solution.*Available: http://www.tencent.com/en-us/at/pr/detail.shtml?id=at_2003_20030909 [2014, March 24].
[18] Pacific Epoch. 2004c. *Tencent Enters Corporate Market; Investment Introduction Plan Launched in North China.*Available: http://pacificepoch.com/china-investment-research/articles/tencent-enters-corporate-market-investment-introduction-plan-launched-in-no/ [2014, March 27].

While Tencent had failed to raise capital from potential investors in the past, PRC regulations further hindered Ma Huateng's attempts to raise borrowed capital through bank loan applications. As a last-ditch effort Tencent turned to foreign investment for funding. However, this too saw complications arising from further PRC regulatory constraints.

4.2.1 PRC Regulations

The year 2000 represented a time when stringent regulatory constraints implemented by the Chinese government exacerbated investment woes for value-added telecommunication service-based companies within the PRC. These regulations restricted foreign companies and foreign-invested enterprises that were incorporated in the PRC from owning or operating value-added telecommunication services in the ordinary course of business. Furthermore, these regulations also extended to both wireless services and internet content service providers. This placed increased pressure on Tencent and its competitors to find alternative legal means to circumvent these regulations. This would allow for potential foreign investment and aid these companies in staying competitive within their market environment.

Tencent adjusted its corporate structure accordingly to circumvent regulatory constraints and encourage foreign investment.

4.2.2 Corporate Structure (see Appendix A, Exhibit 6)

Tencent Holdings Limited (the company) was incorporated in the British Virgin Islands (BVI) on 23 November 1999 and served as a holding company for its indirectly wholly foreign-owned enterprises (WFOE) recognized under PRC law.

On 24 February 2000, the company incorporated Tencent Technology with a registered share capital of US$1,000,000. This was Tencent's first recognized WFOE in the PRC. Tencent Technology was the company's primary operating entity, responsible for software development and holding all principal intellectual property rights of the group. This WFOE was 100% owned

by the company until Tencent Limited[19] became the 100% shareholder on 11 January, 2004. After China joined the World Trade Organization (WTO) on 11 December 2001, the PRC government approved limited foreign investment in value-added telecommunications businesses. While these were limited to WTO documentation this included consulting & management services, software development and trading.

Two years later this led to a definitive change in PRC legislation. On 11 December 2003 Chinese value-added telecommunications businesses were granted a maximum threshold of up to 50% foreign ownership in their companies. These laws extended into permitting foreign investment in the Chinese computer industry, extending to hardware & software development as well as computer technology and information services. However, these grants were subject to terms and conditions defined in the WFOE laws on business scope. Chinese companies offering software implementation services were susceptible to being prohibited from foreign investment at the discretion of the PRC government. This extended to systems and software consulting services as well as systems analysis services.

As Tencent's corporate structure previously stood, its efforts to seek foreign investment contravened Section 4 of the 'Foreign Investment Industrial Guidance Catalogue':

Telecommunication Companies [20]

- Value-added services and paging services in basic telecommunication services: Foreign investments are permitted no later than Dec. 11, 2001 with the proportion of foreign investment not exceeding 30%. The proportion of foreign investment in joint venture shall not exceed 49% no later than Dec. 11, 2002, and shall be allowed to reach 50% no later than Dec. 11, 2003.

- Mobile voice and data services in basic telecommunication services: Foreign investments are permitted no later than Dec. 11, 2001 with the proportion of foreign investment not exceeding 25%. The proportion of foreign investment in joint venture shall not exceed 35% no later than

[19] Tencent Limited is a BVI-incorporated international business company. While established on March 14, 1997, it was a dormant company until it became a wholly-owned subsidiary of Tencent Holdings on December 18, 2003.
[20] People's Republic of China. Ministry of Commerce. 2004. *Catalogue for the Guidance of Foreign Investment Industries.* Available: http://english.mofcom.gov.cn/aarticle/policyrelease/gazette/200505/20050500093692.html [2014, March 31].

Dec. 11, 2002, and shall be allowed to reach 49% no later than Dec. 11, 2004.

- Domestic and international services in basic telecommunication services: Foreign investments will be permitted no later than Dec. 11, 2004 with the proportion of foreign investment not exceeding 25%. The proportion of foreign investment in joint venture shall not exceed 35% no later than Dec. 11, 2006, and shall be allowed to reach 49% no later than Dec. 11, 2007.

Herewith Tencent's product and service portfolio inferred that all three of these regulations were applicable to the company. This meant that Tencent could only offer a total interest stake of 25% to foreign investors. Resultantly, Tencent adjusted its corporate structure to ensure it could raise additional unrestricted capital through foreign investment.

Therefore it formed the following two companies:

Shiji Kaixuan

This limited liability company was established in the PRC on 13 January 2004, with a registered share capital of 11 million RMB. Shiji Kaixuan saw capital contributions from Tencent's five core founders Ma Huateng (47.5%), Zhang Zidong (20%), Zeng Liqing (12.5%), Xu Chenye (10%) and Chen Yidan (10%). This company was formed with the same operational intent as Tencent Computer, both licensed to provide internet information services and other value-added telecommunication services.

Shidai Zhaoyang Technology (Shidai Zhaoyang)

This indirectly-owned WFOE was established in the PRC on 8 February 2004. It yielded a registered share capital of US$500,000 and encompassed a business model of a similar nature to Tencent Technology. Tencent indirectly owned 100% of the WFOE through its wholly-owned subsidiary, Realtime Century Technology Limited (Realtime Century Technology).[21]

[21] Realtime Century Technology is a BVI-incorporated international business company. While established on 14 March 1997, it was a dormant company until it became a wholly-owned subsidiary of Tencent Holdings18 December 2003.

Tencent Holdings, Tencent Technology and Shidai Zhaoyang Technology entered into contractual agreements with Shiji Kaixuan and Tencent Computer. Both entities provided internet value-added (IVAS) and mobile value-added (MVAS) services to the respective entities. These contractual agreements were in compliance with PRC laws and regulations, ensuring that Tencent as the parent company could raise its intended levels of capital funding without facing restrictions on the percentage owned by foreign companies.

4.2.3 Millennium Vocal Limited (MVL) & IDG Technology Venture Investments (IDG)

Circumventing PRC regulatory constraints, Ma Huateng created the opportunity for foreign venture capitalist firms to invest in Tencent. Acting quickly at the height of the Dotcom bubble, Ma Huateng convinced venture capital firms Millenium Vocal Ltd (MVL), a fully-owned subsidiary of Pacific Century Cyberworks Ltd (Hong Kong)[22] and IDG Technology Venture Investments (North America) [23] to invest into the company.

As a precondition to both the IDG and MVL investments, Tencent was required to attract a registered user base exceeding a minimum of four million users. This precondition was met by a multiple exceeding ten times both IDG and MVL's requirements (see Appendix A, Exhibit 3). Each venture capital firm was allotted shares in the company equivalent to their respective US$1.1 million investments. This equated to a 20% interest stake in Tencent for each party.

4.2.4 Myriad Investment Holdings (MIH)

By June 2001, both MVL and IDG faced increased pressure resulting from the Dotcom crash. This was accompanied by concerns over the sustainability of Tencent's business model. At this time many questions were raised concerning the longevity and level of profitability associated with the online instant messaging market space. Considering this time period represented a fickle

[22] Pacific Century Cyberworks Limited was founded by Richard Li, son of Hong Kong business tycoon Li Ka Shing. It later became the PRC's leading telecom operator by acquiring Hong Kong Telecom

[23] Renamed as IDG Capital Partners, IDG is a China-focused venture investment firm founded in 1992. It has invested in more than 200 Chinese companies including the likes Sohu and Baidu

time for those invested in internet companies, both MVL and IDG were quick to sell-off their percentage holdings in Tencent.

As a result, Myriad Investment Holdings (MIH), a subsidiary of South Africa's leading multinational media group Naspers Limited (Naspers), purchased a 46.5% interest stake in Tencent. According to Fritz Demopoulos, the CEO and Founder of Chinese travel search engine Qunar, "It was the most successful deal foreigners have ever made in China's internet sector."[24] The entire purchase consideration (including costs directly attributable to the acquisition) was settled in cash, at a total consideration of R266 million (US$33.25 million).[25]

The cash consideration translated into MIH purchasing:

- 369,341 ordinary shares transferred from MVL
- 243,500 ordinary shares transferred from IDG
- 194,186 ordinary shares from Tencent's founders

Subsequent to this acquisition MIH made an additional R8 million (US$1 million) cash investment, in proportion to its 46.5% shareholding.[26]

Concurrently, IDG transferred its remaining interest of 89,833 shares to its wholly owned North American subsidiary, Mandarin Sea Investments (Mandarin Sea). IDG then converted all of its convertible notes into ordinary shares, transferring an additional 36,008 shares to Mandarin Sea. The total effect of these transactions ensured that both Tencent's founders and MIH each held approximately 46% of legal ownership in the company, while Mandarin Sea held the remaining approximate 7.2% stake.[27]

[24] Sherman, S. & Westland, C. 2010. *Red Wired: China's Internet Revolution.* Available: http://books.google.co.za/books?id=vbqIAAAAQBAJ&printsec=frontcover&source=gbs_ge_summary_r&cad=0#v=onepage&q&f=false [2014, February 28].

[25] This was calculated as at the average exchange rate of R8/US$1 for the May 2001 period.

[26] Naspers. 2001. *Naspers: 2001 Annual Financial Statements.* Available: http://www.naspers.com/ann-results.html [2014, March 31].

[27] Tencent Holdings Limited.2004. *IPO Prospectus- Hong Kong Public Offering and International Placing.* Available: http://globaldocuments.morningstar.com/documentlibrary/document/137bb96118b048a4.msdoc/original [2014, March 31].

4.3 Creating Value for Our Users

June 2001 represented a landmark month for Tencent. After three years of consecutive losses Tencent achieved financial break-even. Deemed as the first month to yield a potential profit since founding in November 1998, this represented a turning point for Tencent moving forward. In light of this, Tencent's financial statements indicated that the company achieved a profit representing 20.8% of revenues generated for the financial year ending 31 December 2001.

While in a profitable position QQ's popularity continued to grow even further. Considering Tencent's costs were variable in accordance with its user base, this increased the company's operating costs. Since Tencent was founded on the concept of free account registration, the QQ account became a status symbol in China. Chinese social status became determinant on a user's QQ account number. This motivated single users to register multiple accounts at any given time, in search of the 'most attractive' QQ account number. Not only did this lead to a misinterpretation of actual QQ users, but it placed concern around the company's level of infrastructure and the possibility of infrastructural expansion to accommodate for an increasing user base. In addition, given that the numbers 6 and 8 are considered lucky numbers in Chinese culture, QQ account numbers were being stolen and consequently sold on the Chinese black market.[28]

In order to combat these problems, Tencent began to deviate from its original pricing model, consequently charging QQ users a registration fee. This angered users and consequently led to a slight decline in QQ's user base. In recognition of this mistake Ma Huateng reverted from this decision, unrestricting all free accounts and re-instating the free registration process. Furthermore, as an alternative means to creating and generating additional revenues Tencent decided to charge for extraneous services such as avatars, virtual gifts and online services. This business decision came to accelerate Tencent's profitability in years to follow.

[28] Wang, X. 2009. *A Mysterious Message Millionaire.* Available: http://www.chinadaily.com.cn/business/2009-01/12/content_7388202.htm [2014, March 24].

4.4 The Chinese Economy (see Appendix A, Exhibit 2)

Over the 1998 to 2003 financial period China's gross domestic product (GDP) grew by a compound annual growth rate (CAGR) of 8.4%. Over this six-year period the Chinese inflation rate ranged between -1.40% and 1.13% (see Appendix A, Exhibit 2) while the per capita annual disposable income of Chinese households grew by 9.4% year-on-year.

As China's population grew by 0.7% over this period, the subscriber base of Chinese internet, fixed line and mobile users grew on average by 106.8%, 24.7% and 60.8% from 1998 to 2003. China boasted the largest fixed line and mobile subscriber base in the world, with 263.3 million and 268.7 million subscribers in each industry, while its internet user base of 79.5 million users was the second largest in the world. In 2003 China enhanced its internet infrastructure in an effort to bridge the digital divide and encourage internet diffusion across the country. The 2003 year saw two million Chinese cable and DSL (Digital Satellite Link) users receive broadband access, three million receive ISDN (Integrated Services Digital Network) access and sixteen million LAN (Local Area Network) users connecting via a leased line.[29]

As at the end of the 2004 year the Asian Development Bank forecasted China's GDP growth as 8.3% (2004), 8.5% (2005), 8.7% (2006), 8.9% (2007) and 9.8% (2008). It also forecasted China's five-year inflation rate as 3.0% (2004), 3.6% (2005), 3.3% (2006), 3.2 (2007) and 2.2 (2008).[30]

4.5 The Competitive Landscape

Tencent competed against four other companies in the Chinese internet and telecommunications value-added service industry – SINA Corp, Sohu.com, NetEase and TOM Online.

Each competitor's company profile can be found in Appendix D, Exhibit 1.

[29] Otani, S. 2005. *The problems faced by China in devising an online landscape with Chinese characteristics.*Available: https://etd.ohiolink.edu/rws_etd/document/get/ohiou1128721263/inline [2014, May 10].
[30] Asian Development Bank. 2014. *Asian Development Outlook.*Available: http://www.adb.org/publications/series/asian-development-outlook?page=1 [2014, July 19].

4.5.1 QQ Instant Messenger

As a pioneer of the Chinese IM market, QQ was a fundamental source of Tencent's annual revenues. QQ played a crucial role in the overall operational construct of Tencent's business model, providing a platform for Tencent to showcase and provide users with its extensive range of value-added product and service offerings. As an effective service platform this created an online community and generated the largest amount of revenues for the company.[31]

Tencent set a precedent in the Chinese internet and telecommunications market by being the first company to apply the freemium model to the Chinese domestic IM market. This is a pricing model whereby a company offers basic products and services for free and then charges users a premium for additional enhanced content and features. By applying the freemium pricing model to Tencent's Basic QQ service this ensured an effective two-fold approach for Tencent to capture the IM market. The Basic QQ service allowed users to enjoy the benefits of the service without having to commit financially. As a result, this attracted a larger potential target market for the company as opposed to charging a premium for the service. Through the registration process Tencent directly promoted its extraneous services to QQ users. Tencent users could then access a host of value-added services through one channel, which significantly reduced the risk of these users migrating to competing offerings.

Tencent's Premium QQ service provided users with additional benefits for a small fee. This included the ability for the user to choose their own QQ account number, providing distinguishable indicators to visibly portray the user's premium status, the ability to store message logs on the QQ servers, additional storage space, additional chat room access and free access to exclusive value-added services. In addition, an entry-level premium service named QQ Xing was launched which charged users a very small monthly fee and provided enhanced security features, the ability to store message logs and storage space.

[31] Tencent Holdings Limited.2004. *IPO Prospectus- Hong Kong Public Offering and International Placing.* Available: http://globaldocuments.morningstar.com/documentlibrary/document/137bb96118b048a4.msdoc/original [2014, April 7].

In a response to Tencent's position in the IM market SINA Corp, Sohu.com and NetEase released IM offerings in 2003. SINA instant messenger, Sohu.com's SQQ and NetEase's POPO failed to compete with QQ and did not affect Tencent's 74.3% stranglehold on the IM market. [32] This forced Tencent's competitors to revert to other alternative measures to generate IVAS revenues and remain competitive in industry.

Since peaking at 100,000 users for the first time in May 2000, Tencent's QQ user base had grown exponentially. By March 2004 Tencent had 291.3 million registered QQ users and approximately 90 million active QQ user accounts. It also had 6 million simultaneous online users, its largest number of simultaneous users achieved since founding (see Appendix A, Exhibit 3). The total average daily user hours of thr QQ community was 18.3 million (2001), 28.6 million (2002) and 51.4 millon (2003). Over this three-year period the average daily messages sent by QQ users were 413.9 million (2001), 386.4 million (2002) and 681.8 million (2003). By March 2004 the average daily user hours were 64.7 million and the average daily messages sent by QQ users were 848.8 million (see Appendix A, Exhibit 3).

4.5.2 Mobile Value-Added Services (MVAS)

Diversifying QQ into a mobile application transformed Tencent's MVAS division into its primary operating segment. By applying the same rollout strategy (as per Section 4.5.1) to its MVAS division, Tencent used the mobile QQ platform to introduce new MVAS and IVAS offerings to its users. As inter-related PC-based and mobile QQ applications, this ensured that the QQ community grew while encouraging greater consumer spending.

Tencent's MVAS division contributed 77.3% (2001), 75.6% (2002) and 63.6% (2003) to the company's overall revenues generated over the 2001 to 2003 financial period (see Appendix A,

[32] SINA Corporation. 2003. *SINA Corporation Annual Report 2003.*Available: http://corp.sina.com.cn/chn/Annual_Report_2003_Final.pdf [2014, April 16].
Sohu. 2003b. *Sohu Annual Report 2003.*Available: http://files.shareholder.com/downloads/ABEA-4Z99DA/3131732366x0x662302/1B6ADA5A-25A6-4D51-ADFF-D665C74CC6AE/2003_Annual_Report.pdf [2014, April 16].
NetEase. 2003. *NetEase Annual Report 2003*.Available: http://media.corporate-ir.net/media_files/IROL/12/122303/docs/netease_2003.pdf [2014, April 16].

Exhibit 5). The MVAS division largely outperformed Tencent's IVAS division over the same financial period. Over the first quarter of the 2004 financial year Tencent's total MVAS revenues exceed the previous year's performance by 69.4%.

By March 2004 the MVAS division was the most competitive operating segment within industry. In order for Tencent and its competitors to ensure that their value-added service offerings reached their respective target markets, these companies had entered into contractual obligations with China's leading mobile operators. China Mobile and China Unicom had complete control of the Chinese cellular telephone market and used its billing and collection systems to profit off the product offerings of Tencent and its competitors. This was the only avenue for Tencent and its competitors to distribute its MVAS services nationally. These contractual relationships enhanced the revenue-generating capacity of Tencent and its competitors at the time.

SINA Corp, Sohu.com, NetEase and TOM Online's MVAS divisions primarily provided content-driven short messaging services (SMS). [33] Collectively SMS content included news and information subscription services, mobile games and entertainment services, matchmaking services, ringtone and picture download services and email services.

During this time Tencent and its competitors began to offer multi-media messaging services (MMS), interactive voice response services (IVRS) and wireless application protocol services (WAP). These new technologies were only recently introduced into the market and were designed for the next generation of smartphones.

Collectively, China's value-added service and SMS revenues in the 2002 financial year were 20,867,144,700 RMB (US$2,521,100,000). According to Tencent's prospectus, the industry was

[33] SINA Corporation. 2003. *SINA Corporation Annual Report 2003.*Available: http://corp.sina.com.cn/chn/Annual_Report_2003_Final.pdf [2014, April 16].
Sohu. 2003b. *Sohu Annual Report 2003.*Available: http://files.shareholder.com/downloads/ABEA-4Z99DA/3131732366x0x662302/1B6ADA5A-25A6-4D51-ADFF-D665C74CC6AE/2003_Annual_Report.pdf [2014, April 16].
NetEase. 2003. *NetEase Annual Report 2003*.Available: http://media.corporate-ir.net/media_files/IROL/12/122303/docs/netease_2003.pdf [2014, April 16].
TOM Online Prospectus. 2004. *TOM Online- Listing on The Growth Enterprise Market of The Stock Exchange og Hong Kong Limited.* Available: http://www.hkexnews.hk/listedco/listconews/SEHK/2004/0629/LTN20040629049.htm [2014, April 09].

expected to grow by 54% in 2003, recording total expected revenue of 32,134,624,800 RMB (US$3,882,400,000). Over the five-year period between the year 2002 and 2007 the total Chinese value-added services and SMS market was expected to grow at a CAGR of 43.3%. The total revenue generated by China's General Packet Radio Service (GPRS) industry in 2002 was 206,925,000 RMB (US$25,000,000). This was expected to grow at a CAGR of 141.8% over the five-year period ending 31 December, 2007.

As at 31 March 2004, Tencent had 12.8 million fee-based registered MVAS subscribers.

4.5.3 Internet Value-Added Services (IVAS)

SINA Corp, Sohu.com, NetEase and TOM Online used their web portals as effective revenue drivers. SINA.com, Sohu.com, 163.com and TOM.com provided content via various channels to ensure that a wide, diverse and multi-functional set of IVAS offerings were available to Chinese consumers.[34] These web portals were each company's primary platform to promote and introduce existing and new IVAS product and service offerings onto the market.

The IVAS services offered were predominantly content-driven and centered on fostering an online community. Content included news, sports, finance, automobiles, women's lifestyle, shopping, real estate, entertainment, games, downloads, astrology, cartoons, information technology and various other topics of interest. To create an online community these companies also offered email, instant messaging (see Section 4.5.1), matchmaking, chat rooms, forums, message boards, alumni clubs and online gaming (MMORPG) services.

The total efforts of the PC-based version of QQ Messenger ensured that Tencent's IVAS division contributed 1.9% (2001), 15.5% (2002) and 31.3% (2003) to its total revenues over the 2001 to

[34] SINA Corporation. 2003. *SINA Corporation Annual Report 2003.*Available: http://corp.sina.com.cn/chn/Annual_Report_2003_Final.pdf [2014, April 16].
Sohu. 2003b. *Sohu Annual Report 2003.*Available: http://files.shareholder.com/downloads/ABEA-4Z99DA/3131732366x0x662302/1B6ADA5A-25A6-4D51-ADFF-D665C74CC6AE/2003_Annual_Report.pdf [2014, April 16].
NetEase. 2003. *NetEase Annual Report 2003*. Available: http://media.corporate-ir.net/media_files/IROL/12/122303/docs/netease_2003.pdf [2014, April 16].
TOM Online Prospectus. 2004. *TOM Online- Listing on The Growth Enterprise Market of The Stock Exchange og Hong Kong Limited.*Available: http://www.hkexnews.hk/listedco/listconews/SEHK/2004/0629/LTN20040629049.htm [2014, April 09].

2003 financial period (see Appendix A, Exhibit 5). As Tencent's QQ user base rose exponentially over this period, this contributed largely to the company's revenue growth. Consequently, Tencent's first quarter 2004 IVAS revenues exceeded previous year's results by 69.4%. These results encouraged the development and rollout of QQ2004 as well as additional IVAS product and service offerings.

Tencent had 1.5 million registered IVAS subscribers by the end of the 2002 financial year. This increased by 360% to 6.9 million in 2003 and had grown to 7.3 million as at 31 March 2004.

4.5.4 Online Advertising

Online advertising represented a core division of Tencent and its competitors. Tencent's online advertising was generated via its QQ software client and QQ.com web portal. With prior consent, Tencent collected personal data from registered users to provide targeted advertising services to corporate clients. This ensured that the adverts were aimed directly at a client's target market by appealing to the specific wants and needs of Tencent's user base. These online advertising campaigns were marketed internally, but the sale of online advertising was outsourced to advertising agencies on a commission basis.

SINA Corp, Sohu.com, NetEase and TOM Online all offered online advertising on their web portals only. [35] These competitors used banners, links, logos and buttons to advertise while Sohu.com also offered email marketing services. TOM Online was the only company to previously offer offline advertising services. However, since making the transition to online advertising the division has significantly underperformed.[36]

[35] SINA Corporation. 2003. *SINA Corporation Annual Report 2003.*Available: http://corp.sina.com.cn/chn/Annual_Report_2003_Final.pdf [2014, April 16].
Sohu. 2003b. *Sohu Annual Report 2003.* Available: http://files.shareholder.com/downloads/ABEA-4Z99DA/3131732366x0x662302/1B6ADA5A-25A6-4D51-ADFF-D665C74CC6AE/2003_Annual_Report.pdf [2014, April 16].
NetEase. 2003. *NetEase Annual Report 2003*. Available: http://media.corporate-ir.net/media_files/IROL/12/122303/docs/netease_2003.pdf [2014, April 16].
TOM Online Prospectus. 2004. *TOM Online- Listing on The Growth Enterprise Market of The Stock Exchange og Hong Kong Limited.* Available: http://www.hkexnews.hk/listedco/listconews/SEHK/2004/0629/LTN20040629049.htm [2014, April 09]

[36] TOM Online. 2004. *TOM Online Annual Report*. Available: http://pr.tom.com/pdf/EW08282_report_2004fy.pdf [2014, July 23].

Online advertising accounted for 0.5% of the total Chinese advertising market for the 2000, 2001 and 2002 financial years (see Appendix A, Exhibit 4). While it was not a widely accepted advertising medium in China, it managed to capture 1% of total Chinese advertising revenues in the 2003 year. In this year China's online advertising revenues totaled 521,451,000 RMB (US$63,000,000). According to Tencent's prospectus, this was expected to grow at a CAGR of 40.4% to 2,847,288,000 RMB (US$344,000,000) over the five-year period ending in 2008.

4.5.5 Commercial Enterprise Solutions

Tencent's RTX software package provided an internal IM network to Chinese enterprises. The major benefit of the RTX package was its interoperability with mobile networks, the QQ network and other existing RTX networks. Chinese enterprises could operate and manage their own internal IM network and use the RTX software package as an effective business communication tool.

Aside from Tencent, only SINA Corp and TOM Online had pursued the Chinese commercial enterprise market. SINA Corp generated enterprise revenues via its paid search and directory listings, corporate email services, classified listings and e-learning. These were targeted at small and medium enterprises (SMEs) and government agencies.[37] TOM Online provided internet-related computer hardware and software to Chinese enterprises. While this division accounted for 17.9% of its 2003 revenues, TOM Online began to phase out the division in the second half of the 2003 financial year.[38]

4.5.6 Untapped Market Potential

4.5.6.1 Online Gaming

China's online gaming market was worth 38,000,000 RMB (US$4,591,035) in the year 2000.[39]

[37] SINA Corporation. 2003. *SINA Corporation Annual Report 2003*.Available: http://corp.sina.com.cn/chn/Annual_Report_2003_Final.pdf [2014, April 07].
[38] TOM Online. 2004. *TOM Online Annual Report.* Available: http://pr.tom.com/pdf/EW08282_report_2004fy.pdf [2014, April 07].
[39] ChinaKnowledge Press. 2004. *China Business Guide: 2004 Edition*.Available: http://books.google.co.za/books?id=yQGlmWPQFR0C&pg=PT120&lpg=PT120&dq=Chinese+internet+users+below+30+in+2004&source=bl&

During the time period between the year 2000 and Tencent's release of QQ Game, Tencent's competitors attempted to enter the untapped online gaming market. In 2003 SINA Corp launched its first MMORPG 'Lineage', but despite its success in Korea it received poor reception in the Chinese market. [40] During the same year Sohu.com launched its first MMORPG 'Knight Online', but this failed to generate forecasted revenues.[41] The most recent failed attempt was TOM Online's 'Karma Online' MMORPG during the first quarter of 2004. [42]

Online gaming was a major revenue driver for NetEase which introduced "PristonTale" and 'Westward Journey Online Version 2.0' in 2002.[43] While 'PristonTale' was an initial success, its user base declined. However, NetEase's most recent offering 'Westward Journey Online Version 2.0' achieved sustainable success, ranked by the 'China Game Industry Report' as one of the Top 10 Most Popular Domestic Developed Games in 2003.

By the end of 2003, China's online gaming industry was worth 1,321,423,050 RMB (US$159,650,000). A study conducted by the International Data Corporation (IDC) stated that the Chinese online gaming industry was expected to grow at a CAGR of 38.8% over the five-year period ending in 2008. [44]

4.5.6.2 Voice over Internet Protocol (VoIP)

VoIP uses Internet Protocol (IP), intranets and extranets to deliver voice information as opposed to traditional telephone services operating on circuit-switched networks.[45] As a packet-switched network, implementing VoIP technology was cheaper than traditional telephone services.[46]

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ots=CPSkUfUzn3&sig=hCkiu207fOGV1MjAToL1fg8GLZk&hl=en&sa=X&ei=RHtOU4rTEcKm0QXujIF4&ved=0CDsQ6AEwAQ#v=onepage&q=Chinese%20internet%20users%20below%2030%20in%202004&f=false [2014, May 11].

[40] SINA Corporation. 2003. *SINA Corporation Annual Report 2003*.Available: http://corp.sina.com.cn/chn/Annual_Report_2003_Final.pdf [2014, July 23].

[41] Sohu.com. 2003a. *Sohu Advances into Online Games with Knight Online*.Available: http://corp.sohu.com/20030225/n240549211.shtml [2014, July 30].

[42] TOM Online. 2004. *TOM Online Annual Report*. Available: http://pr.tom.com/pdf/EW08282_report_2004fy.pdf [2014, April 07].

[43] NetEase. 2003. *NetEase Annual Report 2003*.Available: http://media.corporate-ir.net/media_files/IROL/12/122303/docs/netease_2003.pdf [2014, July 25].

[44] Tencent Holdings Limited.2004. *IPO Prospectus- Hong Kong Public Offering and International Placing.*Available: http://globaldocuments.morningstar.com/documentlibrary/document/137bb96118b048a4.msdoc/original [2014, April 07].

[45] Hu, X. & Wang, R. 2004. *VoIP Development in China. Computer.* 37(9). Available: http://cs.furman.edu/~chealy/fys1107/PAPERS/china%20voip.pdf [2014, May 12].

[46] Wu, I. 2005. *The Triumphant Consumer? VoIP, "Little Smart," and Telecom Service Reform in China*.Available: http://itidjournal.org/itid/article/viewFile/237/107 [2014, May 04].

VoIP was first introduced to the Chinese market in April 1999 as a telephony service and as a pc-based computer-to-computer service. Within three years VoIP telephone traffic surpassed traditional fixed line telephone services.[38] By 2003 China had one of the most advanced VoIP technology frameworks in the world with its VoIP technology superseding the infrastructural and service capabilities of both the USA and Japan.

By May 2004 it was estimated that there were over 5 million VoIP telephony users worldwide.[47] This was expected to grow by 2700% to approximately 140 million users by the end of the 2008.[48]

4.5.6.3 Personal Handy-phone System (PHS)

PHS is a low cost data communication service, using a wireless telephone that functions as both a cordless home telephone and a mobile device elsewhere.[49] PHS handsets are compact and lightweight, with features ranging from color screens to the latest polyphonic ringtones. [50] It is commonly referred to as Xiaolington (XLT) in China, and was offered by both China Netcom and China Telecom.

In 2003 China Netcom and China Telecom both launched PHS SMS services and expanded the data capabilities of their PHS networks. As of June 2003 China's PHS market had 22.5 million subscribers and was expected to grow at an average of 1.5 million new subscribers per month.[51] Over the months of February and March 2004 PHS subscriber growth surpassed previous estimate with an additional 8 million new subscribers. As at the end of March 2004, there was a total of 47.9 million PHS subscribers in China and this was expected to continue growing.[52]

[47] LightReading. 2004. *Report: Yahoo Japan Dominates VOIP*.Available: http://www.lightreading.com/ethernet-ip/report-yahoo-japan-dominates-voip/d/d-id/608444 [2014, July 30].
[48] Biggs, P. 2007. *The Status of Voice Over Internet Protocol (VoIP) Worldwide, 2006*.Available: http://www.itu.int/osg/spu/ni/voice/papers/FoV-VoIP-Biggs-Draft.pdf [2014, May 23].
[49] Rouse, M. 2011. *Definition: Personal Handyphone System (PHS).* Online. Available: http://whatis.techtarget.com/definition/Personal-Handyphone-System-PHS [2014, June 10].
[50] Businesswire. 2005. *In Like a Lion and Out Like a Lamb: 2004 Prospects for the China PHS Market and UTStarcom*.Available: http://www.businesswire.com/news/home/20050629005303/en/Lion-Lamb-2004-Prospects-China-PHS-Market#.U_XhvazlaYA [2014, August 21].
[51] Dean, T. 2004. *PHS in China: Boom or Burst.* Available: http://www.phsmou.org/newsletter/issue48/p2-1.php [2014, August 21].
[52] BDA China. 2004. *China PHS Market Update*.Available: http://www.phsmou.org/newsletter/issue52/p4.php [2014, June 22].

At this time Tencent planned to introduce Mobile QQ and other value-added service offerings to the affordable PHS network. These value-added services were limited by infrastructural constraints, however Tencent admitted that it would expand its PHS efforts as China Netcom and China Telecom continued to develop PHS infrastructure in the near future. These additional value-added services were expected to replicate Tencent's existing product and service portfolio at the time.

4.6 Historical Financial Performance Review (see Appendix A, Exhibit 5)

4.6.1 Mobile Value-Added Services (MVAS)

Table 4.1: MVAS Revenues over the 2001 to 2003 Financial Period

			RMB'000
	2001	**2002**	**2003**
Revenues	37 960	198 818	467 369
Year-on-Year Growth %	**-**	**423.8%**	**135.1%**
Cost of Revenue	(10,801)	(49,856)	(141,916)
Year-on-Year Growth %	**-**	**361.6%**	**184.7%**
As a proportion of Revenues (%)	**25.3%**	**26.3%**	**30.4%**

Tencent's MVAS division was the company's largest revenue contributor over the 2001 to 2003 financial period. Table 4.1 shows that in the 2003 financial year, the total revenue generated by the MVAS division grew by 135.1% to 467,369,000 RMB. This represented 63.6% of total company revenues in that year.

This revenue growth was attributable to the 12.5% increase in Mobile QQ subscriptions. Tencent's Mobile QQ subscriptions rose from 5.6 million registered subscribers to 6.3 million registered subscribers over the 2002/2003 periods. Tencent's MVAS revenue growth was also due to the expansion of its music and picture download services while it also generated greater revenues from its technical support service for which it charged a fee to China Mobile for. This was in relation to 161 Mobile Chat's growing subscriber base.

Table 4.1 shows that Tencent's MVAS costs grew by 184.7% to 141,916,000 RMB in the 2003 year, accounting for 30.4% of Tencent's total MVAS revenues. Overall the MVAS division was the largest cost contributor out of Tencent's operating segments during the 2001 to 2003 financial period. While fees charged by mobile operators increased in line with revenue growth, the rising costs were attributable to an increase in development and technical staff in the 2003 year. This was because Tencent planned to launch new MVAS products and services, while improving existing offerings.

4.6.2 Internet Value-Added Services (IVAS)

Table 4.2: IVAS Revenues over the 2001 to 2003 Financial Period

			RMB'000
	2001	**2002**	**2003**
Revenues	944	40 819	229 690
Year-on-Year Growth %	**-**	**4224.0%**	**462.7%**
Cost of Revenue	(4,223)	(14,848)	(75,489)
Year-on-Year Growth %	**-**	**251.6%**	**408.4%**
As a proportion of Revenues (%)	**-286.8%**	**28.1%**	**32.9%**

Tencent's IVAS division was its second largest operating segment. Table 4.2 shows that there was a significant turnaround in the performance of Tencent's IVAS division as revenues grew 462.7% to a total of 229,690,000 RMB in the 2003 financial year. This contributed 31.3% to Tencent's total revenues generated in that year. This revenue growth was a reflection of a 360% rise in registered QQ subscriptions. This user base grew in 2002 from 1.5 million to 6.9 million registered IVAS subscribers by the end of 2003. Tencent also realized growth in its Premium QQ and QQ Xing services over this period, while generating returns from its promotional efforts surrounding its community services and interactive entertainment offerings.

The increased revenues led to a 408.4% rise in the cost of IVAS revenues. As the second largest cost contributor amongst Tencent's operating segments, costs of 75,489,000 RMB accounted for 32.9% of Tencent's total IVAS revenues in the 2003 year. While the fees collected by mobile operators increased in alignment with revenue growth, the increase in costs was attributable to a

rise in imbalance fees. This was caused by a large traffic imbalance on mobile networks because of the surge in users. To accommodate for the growth in QQ subscribers, Tencent hired additional staff and purchased additional content to keep its QQ.com web portal up to date. Tencent also incurred third party licensing costs in December 2003 for its MMORPG game titled 'Sephiroth' (see Section 4.1.3).

4.6.3 Online Advertising

Table 4.3: Online Advertising Revenues over the 2001 to 2003 Financial Period

			RMB'000
	2001	**2002**	**2003**
Revenues	7 735	19 188	32 841
Year-on-Year Growth %	**-**	**148.1%**	**71.2%**
Cost of Revenue	(3,020)	(6,970)	(10,499)
Year-on-Year Growth %	**-**	**130.8%**	**50.6%**
As a proportion of Revenues (%)	**63.0%**	**33.6%**	**32.0%**

Table 4.3 shows that revenue growth in Tencent's online advertising division slowed down in the 2003 year. Regardless, the online advertising division posted revenues of 32,841,000 RMB in the 2003 year and was Tencent's third largest operating segment. The growth in online advertising revenues was attributable to the surge in both Mobile QQ and QQ members over the 2002/2003 periods. This attracted a greater amount of customers, which was accompanied by Tencent's increased prices.

The total cost of online advertising revenues increased by 50.6% from 6,970,000 RMB in 2002 to a total of 10,499,000 RMB in the 2003. This was representative of 32% of online advertising revenues generated in the 2003 financial year. These costs were attributable to an increase in advertising volumes accompanied by raised advertising agency commissions. Tencent also hired development and technical staff to support the growth of this division.

4.6.4 Other- RTX & Trademark Licensing

Table 4.4: Other Revenues over the 2001 to 2003 Financial Period

			RMB'000
	2001	**2002**	**2003**
Revenues	2 437	4 282	5 057
Year-on-Year Growth %	**-**	**75.7%**	**18.1%**
Cost of Revenue	**-**	**-**	(1,644)
Year-on-Year Growth %	**-**	**-**	**-**
As a proportion of Revenues (%)	**-**	**-**	**32.5%**

This was Tencent's smallest operating segment. Table 4.4 shows its revenues grew 18.1% to 5,057,000 RMB in the 2003 financial year. This was attributable to the launch of RTX in September 2003 (see Section 4.1.4). However, this was offset by a decline in revenues associated with trademark licensing which Tencent reduced as it became more selective in this regard.

As a new division, the total cost of revenues was 1,644,000 RMB in 2003. This represented 32.5% of the total revenues generated by this department in the same year. These costs were directly associated with the commercialization of Tencent's RTX system and its associated sales and support staff.

4.7 Historical IPO Activity in China's Internet and Telecommunications Value-Added Service Industry

The first IPO activity in China's internet and telecommunications industry occurred at the peak of the Dotcom bubble in the year 2000. A cluster of IPO activity occurred over the three-month period dating from April to July 2000. This period saw IPOs launched by SINA Corp, Sohu.com and NetEase on the NASDAQ Stock Market.

Table 4.5: Historical IPO Activity in China's Internet and Telecommunications Value-Added Service Industry

Competitor	Date of IPO	Offer Price Range
SINA Corp	13 April 2000	US$15.00 - US$18.00
Sohu.com	12 July 2000	US$13.00 - US$16.00
NetEase	30 June 2000	US$15.00 - US$16.00
TOM Online - NASDAQ	10 March 2004	US$13.56 - US$15.56
TOM Online - HKGEM	11 March 2004	HK$ 1.30 - HK$ 1.50

Competitor	Actual Offer Price/	Closing Price on First Day of Listing	Percentage Underpricing (%)	Percentage Overpriced (%)
SINA Corp	US$ 17.00	US$ 20.74	22%	0%
Sohu.com	US$ 13.00	US$ 13.00	0%	0%
NetEase	US$ 15.50	US$12.13	0%	27.8%
TOM Online - NASDAQ	US$ 15.55	US$ 15.58	0.2%	0%
TOM Online - HKGEM	HK$ 1.50	HK$ 1.40	0%	6.3%

These companies took advantage of the hot IPO market on the NASDAQ when internet-based companies were in great demand from investors.

Table 4.5 shows that SINA Corp was the first IPO to launch amongst its competitor pool, with an offer price range of US$15.00 to US$18.00 per share. SINA Corp opened on the NASDAQ at US1$17.00 per share, closing at US$20.74 on its first day of trade. This translated into an effective first day's underpricing of 22%, being the largest level of underpricing amongst IPO activity in the industry prior to Tencent's IPO.

NetEase opened at the midpoint of its US$15.00 to US$16.00 range at US$15.50 per share and was the only company amongst its competitors to have overpriced its shares and close the first day of trade 27.8% down to US$12.13 per share. This was a result of the Chinese portal space becoming overcrowded, while market sentiment surrounding the NetEase IPO was further damaged by Sohu.com's announcement that it would launch its IPO twelve days after.[53]

[53] Chu, V. 2000. *Sohu lifts IPO price range.*Available: http://www.marketwatch.com/story/china-internet-ipos-face-dubious-welcome [2014, August 21].

Underwriters of Sohu.com's IPO originally priced the offer shares at a range of US$13.00 to US$16.00 per share. Prior to the launch of NetEase's IPO, underwriters raised the price to a range of US$16.00 to US$19.00 per share.[54] This was in response to the success of SINA Corp's IPO and the positive market sentiment surrounding internet stock investments up to that point.

However, Sohu.com's underwriters were forced to revert back to the original US$13.00 to US$16.00 price range. This was in response to changing market sentiment and poor reception received by NetEase's IPO.[55] Sohu.com's offer shares closed unchanged on its first day of listing at US$13.00 per share. [56]

In 2004 TOM Online dual-listed on both the NASDAQ and the Hong Kong Growth Enterprise Market (HKGEM). It opened on the NASDAQ one cent below the top of its offer price range, at US$15.55 per share. It closed its position with a 0.2% gain at US$15.58 per share.[57] TOM Online's HKGEM listing was priced at the top of its offer price range, at HK$1.50 per share. The share underperformed on the Growth Enterprise Market (GEM), overpriced by 6.3% to close the first day of trade at HK$1.40 per share. This was attributable to investor worries surrounding intense competition in China's wireless messaging industry.[58]

4.8 The IPO Process

A summation of Tencent's IPO comes from a quote by Teresa Ko, a partner at Freshfields Bruckhaus Deringer, the legal adviser of Goldman Sachs (Tencent's lead underwriter) during the time of the IPO, "This was a groundbreaking transaction in that it was the first ever Chinese internet company to be listed on the Main Board of the (Hong Kong) Stock Exchange."[59]

[54] Clifford, B. 2000. *Sohu lifts IPO price range.*Available: http://www.marketwatch.com/story/sohu-lifts-ipo-price-range-sina-targets-shanghai [2014, August 21].
[55] Clarke, T. 2000. *Sohu.com receives lukewarm reception on Nasdaq debut.*Available: http://www.financeasia.com/News/32497,sohucom-receives-lukewarm-reception-on-nasdaq-debut.aspx [2014, August 21].
[56] *A Flat Open for Sohu.com.* 2000. CNN Money. 12 July. Available: http://cnnfn.cnn.com/2000/07/12/companies/sohu/ [2014, August 5].
[57] Gelsi, S. 2004. *TOM Online* Flat in Debut. Available: http://www.marketwatch.com/story/tom-online-ipo-flat-in-debut [2014, July 06].
[58] Baijia, L. 2004b. Tom Online stock price ends flat.Available: http://www.chinadaily.com.cn/english/doc/2004-03/12/content_314259.htm [2014, July 31].
[59] Asia Law. 2009. *Asia Law IPO Retrospective*.Available http://www.asialaw.com/Article/1971955/IPO-Retrospective.html?Print=true&Single=true [2014, April 01].

On 5 December 2003, it emerged that Naspers (MIH) began investigating the feasibility of a possible Tencent initial public offering (IPO) at some point in 2004.[60] While details were limited, it was clear that this would depend on prevailing market conditions. At this time a potential listing was considered on the HKEx or alternatively the Johannesburg Stock Exchange (JSE).[61]

Regardless of the possible listing alternatives as per Naspers's JSE Stock Exchange News Service (SENS) announcement, a Chinese news publication the China Daily, reported the possibility of Tencent listing the IPO on the North American NASDAQ Stock Exchange.[62] While neither Tencent nor Naspers raised this possibility publically, there was speculation surrounding a NASDAQ listing as a result of previous industry IPO trends (see Section 4.7). In seeking clarity on Tencent's chosen listing platform, it was leaked via Chinese media that a Tencent 'insider' confirmed the likelihood of the company deferring its NASDAQ listing for the HEKx. It was suggested that this was because Tencent's existing IFRS/HKFRS accounting structure was unsuitable in terms of US regulations and the NASDAQ listing requirements.[63]

On 27 February 2004, Tencent transferred its company registration from the British Virgin Islands (BVI) to the Cayman Islands in anticipation of its IPO listing on the HKEx. This decision avoided having to place a newly incorporated entity into the Cayman Islands and then having to use this new entity as an effective listing vehicle of the Group. Had this happened, then the associated South African Capital Gains Tax (CGT) implications would have disadvantaged Naspers (MIH). As an additional benefit of Tencent's decision to redomicile to the Cayman Islands, the company did not have to transfer its existing contracts to the new Cayman Island company.

[60] JSE SENS. 2003a. *Naspers Limited – Announcement.* 5 December. Available: http://data.moneyweb.co.za/moneyweb/sharedata/scripts/sens.asp?id=54173 [2014, March 31].
[61] JSE SENS. 2003b. *Plans for Tencent IPO lift Naspers' Share Price*.8 December. Available: http://data.moneyweb.co.za/moneyweb/sharedata/scripts/sens.asp?id=54237 [2014, March 31].
[62] Baijia, L. 2004a. *Rising Stars Impact Net Industry.* Available: http://www.chinadaily.com.cn/en/cd/2004-02/04/content_302877.htm [2014, March 31].
[63] Pacific Epoch.2004b. *Tencent Could Skip NASDAQ for HKEx Listing*. Available: http://www.pacificepoch.com/china-investment-research/articles/tencent-could-skip-nasdaq-for-hkse-listing [2014, March 31].

To obtain the above-mentioned approval to list on the HKEx, Tencent had to issue and register its company prospectus with the Hong Kong Registrar of Companies. This company prospectus was submitted on Friday, 02 April 2004.

In order to be eligible to list on the HKEx Main Board Tencent had to meet at least one of three mandatory HKEx financial tests[64]:

- The Profit Test
- The Market Capitalization/Revenue Test
- The Market Capitalization/Revenue/Cash Flow Test

Tencent superseded all requirements pertaining to the Profit Test and Market Capitalization/Revenue/Cash Flow Test (see Appendix A, Exhibit 8).

Table 4.6: Tencent's Eligibility to List on the HKEx Main Board

	The Profit Test	The Market Capitalization/Revenue Test	The Market Capitalization/Revenue/Cash Flow Test
Trading Record	✓	✓	✓
Management Continuity	✓	✓	✓
Ownership Continuity and Control	✓	✓	✓
Market Capitalization	✓	✓	✓
Profit from Continuing Operations	✓	X	✓
Aggregate Profits	✓	N/A	✓
Revenue	N/A	✓	✓
Positive Cash Flow from Operations	N/A	N/A	✓
Minimum Shareholders	N/A	✓	N/A
Eligible to List on the HKEx Main Board	**YES**	**NO**	**YES**

Table 4.6 summarizes Tencent's eligibility to meet the stipulated requirement of each financial test. Using this table in conjunction with Exhibit 8 of Appendix A, it was clear that Tencent's Tencent's trading record exceeded three financial years, its management team stayed consistent throughout this period and that there were no changes in ownership, continuity or control in its most recent audited financial year. Tencent's expected post-IPO market capitalization of between

[64] HKEx.2004a. *Chapter 8- Equity Securities: Qualifications for Listing*. Available: https://www.hkex.com.hk/eng/rulesreg/listrules/mbrulesup/documents/ch%208.pdf [2014, April 02]

HK$4,655,376,920 and HK$6,451,561,462 exceeded the HK$200 million, HK$2 billion and HK$4 billion market cap threshold requirements of each test at the time of listing (see Appendix A, Exhibit 8).[65]

As the main determinant of the Profit Test, Tencent's 2003 profit exceeded the required profitability level of HK$20 million by HK$283,958,490 [66], while profits for both the 2001 and 2002 financial years exceeded an aggregate required threshold of HK$30 million by HK$112,306,893.[67] As the main determinants of the Market Capitalization/Revenue/Cash Flow Test, 2003 revenues exceeded the HK$500 million threshold by HK$1,933,556,60 [68] while positive cash flow from operating activities was HK$348,898,157 more than the aggregate HK$100 million threshold over the past 3 years.[69] However, Tencent did not meet the main stipulated requirement of the Market Capitalization/Revenue Test (see Appendix A, Exhibit 8). This was because its primary operating segment, the MVAS division, generated HK$440,914,150 [70] which fell HK$59,085,849 short of the required HK$500 million threshold.

Ten days after submitting its prospectus, Tencent entered into its pre-IPO quiet period or cooling-off period. This prohibited the company from publicly enhancing its name or encouraging favorable attitudes towards its offer shares.[71] Any such prohibited activity was illegal up until the day the company listed, and such actions would have prevented the firm from listing.

In keeping with legislative compliance, both Tencent and Naspers (MIH) decided not to sign a post-IPO non-competition deed. [72] The premise behind this decision was that the companies believed they had established a healthy business relationship. Both companies provided services to each other and entered into transactions together on an arm's length basis in accordance with

[65] This range is calculated to encompass both possible outcomes of the IPO, accounting for the original amount of offer shares on offer, as well as the over-allotment option.
[66] [(322,196,000 RMB / 1.06 = HK$3,039,584,90) – (HK$20,000,000) = HK$283,958,490]
[67] [(10,216,000 RMB / 1.061 RMB) + (140,707,000 / 1.060513 RMB) – (HK$30,000,000) = HK$112,306,893]
[68] [(734,957,000 RMB / 1.06 RMB) – HK$500,000,000 = HK$348,898,157]
[69] [((20,760,000 RMB /1.061 RMB) + (91,759,000 RMB /1.060513 RMB) + (363,377,000 RMB / 1.06 RMB)) – HK$100,000,000 = HK$3, 488, 981, 57.
[70] [467,369,000 RMB / 1.06 RMB = HK$440,914,150]

[71] Pacific Epoch.2004d. *Tencent in Pre-IPO Quiet Period – Internet Weekly.* Available: http://pacificepoch.com/china-investment-research/articles/tencent-in-pre-ipo-quiet-period-internet-weekly// [2014, March 31].
[72] Tencent Holdings Limited.2004. *IPO Prospectus- Hong Kong Public Offering and International Placing.* Available: http://globaldocuments.morningstar.com/documentlibrary/document/137bb96118b048a4.msdoc/original [2014, April 07].

regulatory requirements. Considering these transactions were conducted on commercial terms and ethical grounds to ensure that shareholders were satisfied, both parties agreed to enter into an amended and restated Shareholders Agreement on 20 April 2004 (see Appendix A, Exhibit 7).

Prior to Tencent's roadshow analysts said that the IPO was pitched at a range of 15 to 25 times the company's 2004 earnings.[73] This was regarded as a wide valuation range considering the negative market sentiment surrounding internet and technology stocks at that time. Therefore, it was expected that the offer shares would be priced at the bottom end of the range at HK$2.77 per share. By the time Tencent began the roadshow, the range was considerably reduced to approximately 11.5 to 15.5 times earnings.[74] This was attributable to improved market sentiment, a growing interest in Chinese internet stocks and an attractive yet realistic company valuation.[11] Hence, Tencent strategically built its book around a cheaper company valuation to ensure the offer was enticing enough to all types of investors.

Tencent began its IPO roadshow on Monday, 10 May 2004. It presented to analysts, fund managers and potential investors about the company, its achievements, financial history, management's potential and the ability to grow in the future.[75] In alignment with the pre-IPO quiet period this was undertaken in a private capacity. Most significant to the roadshow was senior management's promise that they would not sell any of their shares inside a 180-day period post the IPO listing date.[76] While this lock-up period was a mandatory requirement of the HKEx, this would have stimulated greater investor confidence and surety on potential investments. This would have assured investors that Tencent's directors wouldn't simply convert their personal shares into cash by selling them off once the company was listed.

Upon completing the roadshow, Tencent made copies of its prospectus publicly available along with both white and yellow application forms. This was for a limited four-day period extending

[73] Horne, J. 2004a. *Tencent launches pre-marketing*.Available: http://www.financeasia.com/search/~/News/31880,tencent-launches-pre-marketing.aspx [2014, July 16].
[74] Horne, J. 2004b. *Tencent gets top dollar*.Available: http://www.financeasia.com/News/26962,tencent-gets-top-dollar.aspx [2014, July 16].
[75] Pacific Epoch. 2004e. *Tencent Starts IPO Roadshow; To Raise US$200M – ChinaByte*.Available: http://pacificepoch.com/china-investment-research/articles/tencent-starts-ipo-roadshow-to-raise-us200m-chinabyte/ [2014, March 31].
[76] Pacific Epoch. 2004a. *Ma Huateng: Acquisitions In Accordance With Prospectus; Senior Executives Will Not Cash Out In Six Months*. Available: http://pacificepoch.com/china-investment-research/articles/ma-huateng-acquisitions-in-accordance-with-prospectus-senior-executives-wil/ [2014, March 31].

from Monday, 7 June 2004 up until 12 noon on Thursday, 10 June 2004. This was the only time period available for potential investors to apply both manually, using white and yellow application forms, and electronically through the Central Clearing and Settlement System (CCASS).

4.8.1 Structure of the Offering (see Appendix B, Exhibit 1, Exhibit 2, Exhibit 3)

The offering was constructed in order for Tencent to gain access to further funding through the Hong Kong equity market. Tencent did not stipulate a minimum intended level of capital to be raised from the IPO.

Table 4.7: Overview of the Structure of Tencent's IPO Offer

Offer Price Range	HK$2.77 - HK$3.70
Nominal Value Per Share	HK$0.0001
Underwriters	Goldman Sachs (Asia) HSBC
Global Coordinator, Bookrunner, Lead Underwriter and Sponsor	Goldman Sachs (Asia)
Hong Kong Public Offering	
Pool A *(Aggregate Subscription Price of HK$5,000,000 or Less)*	21 008 000
Pool B *(Aggregate Subscription Price of More Than HK$5,000,000 or Up to the Value of Pool B)*	21 008 000
Total Hong Kong Offer Shares Available	**42 016 000**
International Placing	
Total International Placement Shares Available	**378 144 500**
Total Amount of Offer Shares Available	**420 160 500**

There were two facets to the Tencent IPO offer shares. Table 4.7 shows that the offering consisted of both a Hong Kong Public Offering, and an International Placement:

- Hong Kong Public Offering: 42,016,000 offer shares made available.
(Approximately 10% of total issued share capital after completion of the offering)
- International Placing: 378,144,500 offer shares made available.
(Approximately 22.5% of total issued share capital after completion of the offering)

The Hong Kong Offer Shares were further split into two pools:

Pool A: Allocated on an equitable basis to those who applied for offer shares with an aggregate subscription price of HK$5,000,000 or less.[77]

Pool B: Allocated on an equitable basis, to those who applied for offer shares with an aggregate subscription price of more than HK$5,000,000 and up to the value of Pool B.[78]

Goldman Sachs (Asia) L.L.C (Goldman Sachs) was the global coordinator, lead underwriter, bookrunner and sponsor of Tencent's IPO. Furthermore, Goldman Sachs was also the lead underwriter of the IPO along with the Hongkong and Shanghai Banking Corporation Limited (HSBC). Both underwriters did not hold any shareholding interest in Tencent, neither did they have the right nor option to subscribe for offer shares in the company. This further extended to nominations, which were prohibited.

Upon completion of the application period and share allocation procedure, it was further confirmed that no offer shares were allocated to connected persons of the company, and that neither the sponsor nor underwriters (Goldman Sachs) took any Shares for their own benefit.[79]

[77] These values exclude brokerage fees (1%), Stock Exchange trading fees (0.005%), SFC transaction levies (0.005%) as well the investor compensation fees (0.002%) payable.
[78] These values exclude brokerage fees (1%), Stock Exchange trading fees (0.005%), SFC transaction levies (0.005%) as well the investor compensation fees (0.002%) payable.
[79] Tencent. 2004b. *Hong Kong Public Offering and International Placing.*Available: http://www.hkexnews.hk/listedco/listconews/SEHK/2004/0607/LTN20040607055.pdf [2014, March 27].

The deal construct ensured that the underwriters would receive a gross commission of 4.0% of the aggregate offer price of both Hong Kong Offer Shares and International Placing shares. This excluded sub-underwriter commissions directly payable in their personal capacity. It was further stated that at the discretion of Tencent the underwriters would receive a share incentive fee of 0.5% of the offer price of Hong Kong Offer Shares. Comparing this to the TOM Online IPO on the HKEx Growth Enterprise Market (GEM) in March 2004, the gross commission earned by their underwriters was 2.5%.[80]

This suggests that Tencent's underwriters were well-compensated for their services and were set to earn a large commission provided that Tencent was a hot IPO. In preparing for the potential over-allotment of its offer shares, Goldman Sachs and Tencent included a greenshoe provision in the underwriting agreement exclusively for international investors (see 2.2 of Exhibit 2 in Appendix B).

A greenshoe provision permits the underwriter to sell up to 15% more shares than originally planned for by the issuing company. This greenshoe provision allowed Tencent to issue and allot an additional 15% of the offer shares available, representing an aggregate of 63,024,000 additional shares at the original offer price.

[80] TOM Online Prospectus. 2004. *TOM Online- Listing on The Growth Enterprise Market of The Stock Exchange og Hong Kong Limited.* Available: http://www.hkexnews.hk/listedco/listconews/SEHK/2004/0629/LTN20040629049.htm [2014, April 09].

Table 4.8: Tencent IPO Share Allotment after Exercising the Greenshoe Provision

Hong Kong Public Offering	42 016 000
Pool A *(Aggregate Subscription Price of HK$5,000,000 or Less)*	21 008 000
Pool B *(Aggregate Subscription Price of More Than HK$5,000,000 or Up to the Value of Pool B)*	21 008 000
Total Hong Kong Offer Shares Available	**210 080 250**
International Placing	378 144 500
Total International Placement Shares Available	**210 080 250**
Add: Over-Alloted Shares (15%)	63 024 000
Total Amount of Offer Shares Available ***(Includes the Over-Allotment Option)***	**483 184 500**

Table 4.8 shows that the over-allotment option raised the total amount of offer shares to 483,184,500. In order to obtain the additional 63,024,000 shares required to undertake the over-allotment option, Goldman Sachs borrowed these shares from Ma Huateng's BVI-incorporated Advance Data Services Limited (Advance Data Services) through a stock borrowing arrangement (see point 2.4.1 of Exhibit 2 in Appendix B).

These additional 63,024,000 shares were returned and redelivered to Advance Data Services after they were issued as per the over-allotment option. Evidently, this stock borrowing agreement led to indirect benefits for Tencent. Thus, on 4 June 2004 Tencent signed a Deed of Indemnity that they would indemnify Advanced Data Services for any losses that arose if they were unable to recover from the stock borrowing arrangement.

After receiving the relevant applications from prospective investors, both Tencent's Hong Kong Offer Shares and International Placement Shares were oversubscribed. Acting on this, Goldman Sachs fully exercised its over-allotment option on 05 July 2004 (see 2.1.1.1.1 of Exhibit 2 in Appendix B). This was the only stabilizing action taken by Goldman Sachs during the stabilizing period.[81] Tencent's Hong Kong Offer Shares were 159 times oversubscribed while shares in the International Placement were 17 times oversubscribed, indicating strong investor confidence in Tencent and its future outlook.

Exercising the over-allotment option allowed Tencent to raise greater amounts of capital by meeting excess demand for its shares and to achieve its primary objective surrounding the IPO decision. By granting the underwriter the option to purchase and short-sell an additional 15% of total offer shares, this allowed Goldman Sachs to cover their short position while stabilizing Tencent's share price simultaneously. The impact of this was that if the share price was consistently above Tencent's offer price, the underwriters could exercise the greenshoe provision and repurchase the additional 63,024,000 shares at the offer price. This would ensure that Tencent could raise additional capital while the underwriters do not lose money.

On the contrary, a decline in the market price below the initial set offer price may alarm investors and encourage them to sell their shares. To stabilize the share price, Goldman Sachs would have had to exercise the option to repurchase the additional 63,024,000 shares at the original offer price. By repurchasing these shares and returning them to Tencent, the underwriter would have reduced the supply of Tencent shares on the market and effectively stabilized the share price from declining further.

Translating the oversubscription of Hong Kong Offer Shares into numerical terms, of the 6,657 applications received and approved 5,854 (87.9%) were in respect of Pool A offer shares while 803 (12.1%) were in respect of Pool B offer shares. This approximated to a total demand of 1,170,853,000 Pool A offer shares and 5,527,560,000 Pool B offer shares by prospective applicants.

[81] Stabilization is the process whereby underwriters in some markets facilitate the distribution of securities on the exchange. In this case, Goldman Sachs, being the Global Coordinator and acting as both an underwriter and on behalf of HSBC; may over-allot shares or effect transactions for the purpose of ensuring a market price higher than what could initially be achieved. This is for a limited time period and is non-obligatory. The stabilization period ended on July 10 2004.

Overall, this represented an oversubscription of 55 times and 263 times the 21,008,000 Hong Kong Offer Shares allocated to each respective pool. With reference to point 1.1.2 of Exhibit 2 in Appendix B, at the time of reviewing the received applications there was no evidence indicating that any single applicant applied for an amount of Hong Kong Offer Shares exceeding the 21,008,000 (50%) threshold per applicant.

As a safeguard to exercising the over-allotment option, Tencent's prospectus indicated that a clawback mechanism was in-place to accommodate for potential oversubscription of offer shares. The clawback mechanism was a policy officially implemented by the Securities & Futures Commission of Hong Kong (SFC) and the HKEx in Practice Note 18 on 24 June 1998. This policy was compulsory for all IPO firms on the HKEx which comprised of both a placing tranche and a public subscription tranche.[82]

[82] SFC. 1998. *SFC and Stock Exchange Issue Conclusions on Offer Mechanism Consultation*.Available: http://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=240298 [2014, July 11].
HKEx. 1998. *The Stock Exchange of Hong Kong Limited- Practice Note 18.* Available: http://www.hkex.com.hk/eng/rulesreg/listrules/listguid/iporq/Documents/m_pn_18.pdf [2014, July 11].

Table 4.9: The Effect of the Clawback Provision on Tencent's IPO Share Allotment

Hong Kong Public Offering	42 016 000
Pool A *(Aggregate Subscription Price of HK$5,000,000 or Less)*	21 008 000
Pool B *(Aggregate Subscription Price of More Than HK$5,000,000 or Up to the Value of Pool B)*	21 008 000
Add: Clawback Provision	168 064 250
Total Hong Kong Offer Shares Available	**210 080 250**
International Placing	378 144 500
Less: Clawback Provision	-168 064 250
Total International Placement Shares Available	**210 080 250**
Total Amount of Offer Shares Available *(Excludes the Over-Allotment Option)*	420 160 500
Add: Over-Alloted Shares (15%)	63 024 000
Total Amount of Offer Shares Available ***(Includes the Over-Allotment Option)***	**483 184 500**

Exhibit 1 of Appendix B shows that if the number of offer shares applied for in the Hong Kong Public Offering was 100 times or more the amount initially allocated; the total number of offer shares available under the Hong Kong Public Offering would be increased to represent approximately 50% of the total number of offer shares available under the offering. This 50% translated into an equivalent 210,080,250 offer shares. Resultantly, Table 4.9 shows that this re-allocation saw 168,064,250 offer shares transferred from the International Placement to the Hong

Kong Public Offering, generating an equivalent amount of 210,080,250 offer shares per each placement type.

Should the level of investor interest have been less pronounced, there would have been a reduction in either the offer price range or the amount of offer shares made available (see Appendix B, Exhibit 1).[83] While this would have been based on interest levels during the book building process, any action from the global coordinator in this regard may only have become public knowledge on the second last day before the end of the application process. Should this have been the case, this 'late' announcement could have frustrated applicants within the Hong Kong Public Offering segment as they were prohibited from withdrawing their application once submitted.

Juxtaposed to this precautionary announcement, the initial offering (excluding the over-allotment option) raised HK$1,554,593,850 (US$199,360,578) at the confirmed offer price of HK$3.70 per share. This saw a shareholder allocation apportioned 90% to institutional investors and the remaining 10% to retail investors. However, the over-allotment and the clawback provision ensured that the shares were equally redistributed, with 50% awarded to retail investors and 50% to institutional investors. The over-allotted shares raised an additional HK$233,188,800 (US$29,904,051) raising total offer proceeds to HK$1,787,782,650 (US$229,264,629).

In total, the IPO deal represented 3.75% of Tencent's existing issued share capital at the time, and an approximate 3.61% of its issued share capital inclusive of the over-allotment shares.[84] For a comprehensive breakdown of Tencent's shareholding structure please refer to Appendix B, Exhibit 3.

[83] Tencent Holdings Limited.2004. *IPO Prospectus- Hong Kong Public Offering and International Placing.* Available: http://globaldocuments.morningstar.com/documentlibrary/document/137bb96118b048a4.msdoc/original [2014, April 04].
[84] Tencent. 2004b. *Hong Kong Public Offering and International Placing.*Available: http://www.hkexnews.hk/listedco/listconews/SEHK/2004/0607/LTN20040607055.pdf [2014, March 27].

4.9 Use of IPO Proceeds

Tencent planned to allocate IPO proceeds to pursue and finance new strategic initiatives, expand its existing business and achieve organic growth.

Of the original HK$1,554,593,850 (US$199,360,578) proceeds raised (exclusive of the over-allotment option), 65% (HK$1,010,486,003 / US$129,584,376) was allocated to pursue and finance new strategic initiatives in the real-time communications, entertainment and internet sectors. 20% (HK$310,918,770 / US$39,872,116) was allocated for further development of current and future technologies, content licensing, improving customer service segments and upgrading billing and collection services. The remaining 15% (HK$233,189,077/ US$29,904,087) was allocated to fund working capital and other general corporate purposes. The additional over-allotment proceeds of HK$233,188,800 (US$29,904,051) was allocated to fund Tencent's working capital.

Tencent's aim to diversify its operations ensured potential acquisitions of third-party technology developers and service providers. These ranged from VoIP technologies, mobile location-based technologies and business advertising rank technologies to MMORPG and real-time strategy (RTS) games as well as consumer-to-consumer (C2C) and business-to-consumer (B2C) IM-enabled platforms. While Tencent did not make explicit mention of specific target companies, each acquisition would enhance and complement its existing product and catalogue.

4.10 The Day of Listing

On Wednesday, 16 June 2004 Tencent Holdings Limited (stock code: 700) was approved for listing on the HKEx. Trading commenced at 09:30 am opening at HK$4.375. The share peaked at HK$4.625 before closing at HK$4.150 on the same day.

Tencent shares were the second most actively traded shares on the HKEx that day, with a volume of 2,198,875,000 shares traded.

Chapter 5: The Listing Decision – A Strategic Rationale for the IPO

Research by Ernst & Young (EY) indicates that those companies which achieve strong post-IPO performance link this success to treating the IPO as a transformation process and not simply as an isolated financing event (EY, 2013: 04). This is evident from the likes of Tencent which too has come to reap the rewards of its IPO offering over the past decade of listing.

However, in order for an IPO decision to come to fruition successfully, a variety of strategic considerations must be accounted for. It is this strategic rationale which, combined with the company's pre-IPO policies and procedures will inevitably determine the success of this decision.

5.1 HKEx vs NASDAQ: The Listing Decision

Tencent filed for an IPO to raise further capital through the Hong Kong equity market. As per Section 4.9, these generated proceeds would be used to organically grow and expand the existing business through company acquisitions and strategic initiatives. In doing so, this would ensure that Tencent protected its market position and remained competitive in the Chinese internet and telecommunications industry.

Table 4.5 in Section 4.7 shows that three out of four industry competitors favored the NASDAQ Stock Market to launch their IPOs. These entities listed on the NASDAQ during the peak of the Dotcom bubble in the year 2000.

The fourth competitor, TOM Online launched its IPO in the same year as Tencent. Within one day of each other, TOM Online dual-listed on both the HKGEM and NASDAQ.

Before examining the strategic rationale behind Tencent's listing decision it is important to assess Tencent's eligibility to list on the NASDAQ National Market. To be eligible to list on the NASDAQ National Market a company had to meet at least one of the entry standards in Table 5.1. Entry standard 1 (the income standard) used pre-tax income from continuing operations as its primary factor of assessment. Entry standard 2 (the equity standard) used shareholders' equity as its primary factor of assessment, while entry standard 3 (the market value standard) used the market value of listed securities or the total assets and total revenue of the company as its primary factor of assessment (see Appendix C, Exhibit 1 for a detailed description of these standards).

It is clear from Table 4.6 in Section 4.8 that Tencent met the HKEx's Profit Test and Market Capitalization/Revenue/Cash Flow Test to list on the Main Board of the exchange in the 2004 year (also see Appendix A, Exhibit 8).

Table 5.1: Tencent's Eligibility to List on the NASDAQ National Market

	Entry Standard 1 The Income Standard	Entry Standard 2 The Equity Standard	Entry Standard 3 The Market Value Standard
Shareholders' Equity	✓	✓	N/A
Market Value of Listed Securities	N/A	N/A	✓
OR			OR
Total Assets and Total Revenue			✓ ✓
Income from Continuing Operations (Before Income Tax) in the Latest Fiscal Year or in 2 of the Last 3 Years	✓	N/A	N/A
Publicly Held Shares	✓	✓	✓
Market Value of Publicly Held Shares	✓	✓	✓
Minimum Bid Price	✓	✓	✓
Shareholders (Round Lot Holders)	✓	✓	✓
Market Makers	✓	✓	✓
Operating History	N/A	✓	N/A
Percentage Compliance with NASDAQ Listing Requirements (%)	100%	100%	100%

Table 5.1 summarizes the NASDAQ National Market listing requirements and shows that Tencent, like its competitors four years prior, was completely eligible to launch an IPO on the NASDAQ in 2004 (see Appendix C, Exhibit 1).

In light of Tencent's decision to list on the HKEx Main Board, it is therefore of relevance to explore this IPO listing decision and the strategic rationale behind Tencent's decision to defy historical industry IPO listing trends.

5.2 British Virgin Islands (BVI) and The Cayman Islands

5.2.1 Incorporating in the BVI

The primary reason that PRC companies chose to incorporate in the BVI was because it was a tax haven, [85] and therefore provided an opportunity for these companies to partake in tax avoidance.[86]

Based on the information in Section 4.8, it may be questioned why Tencent did not originally choose to simply incorporate in the Cayman Islands and thus avoid the subsequent complications surrounding its corporate structure altogether. This can be attributed to cost. The costs associated with incorporating a BVI company were approximately 20% lower than the costs associated with incorporating in the Cayman Islands (Schilder, 2011: 01).

Ten percent of all foreign investments in China are from companies that are incorporated in the BVI (Tax Justice Network, 2011). In this context, many Chinese companies leave their monies in the BVI for an extended period of time. Once an appropriate time period has elapsed, this money is sent back into China in the guise of foreign investment. By ensuring an appropriate time period has elapsed, this guarantees that there are no capital gains tax (CGT) implications on these earnings. Should a Chinese company directly deposit money into China upon receiving it, this method would incur direct capital gains tax consequences.

[85] Tax Haven – This is a state, country or territory offering foreign individuals and businesses little or no tax liability in a politically and economically stable environment. Furthermore, they too provide little or no financial information to tax authorities.

[86] Tax Avoidance – This is a legal practice, and makes use of legal methods to modify a businesses or individuals financial situation to lower their income tax owed.

Tax Evasion – This is an illegal practice, whereby a business or individual avoids paying their true tax liability. This is a criminal offense subject to penalties and criminal charges.

5.2.2 Redomiciling to the Cayman Islands

At the time of Tencent's IPO, the listing regulations of the HKEx Main Board only permitted companies registered in Hong Kong, Mainland China, Bermuda and the Cayman Islands to list in on the exchange (HKEx, 2006; EY, 2009). This was because the legislation of these areas met with the HKEx's minimum required standards surrounding shareholder protection rights. This meant that the shareholder protection rights of BVI legislation were not of the required HKEx standard and consequently Tencent was not permitted to list on the exchange.

The transfer of Tencent's company registration from the BVI to the Cayman Islands represented a core strategic move in its efforts to go public. This decision further solidified the company's intentions to list on the HKEx as its exchange of choice, quashing earlier speculation associated with its potential listing platforms (see Section 4.8).

Rule 19.05 in Chapter 19 of the HKEx Main Board Listing Rules specifies the following:

The Exchange reserves the right, in its absolute discretion, to refuse a listing of securities of an overseas issuer if: -

(a) it believes that it is not in the public interest to list them; or

(b) the Exchange is not satisfied that the overseas issuer is incorporated or otherwise established in a jurisdiction where the standards of shareholder protection are at least equivalent to those provided in Hong Kong.

(HKEx, 2004b: 01)

In reference to point (b), there were striking differences in the constitutional documents surrounding shareholder protection rights between the BVI Act and Cayman Island legislation. However, in accordance with rule 19.05(1) the HKEx drafted an alternative solution for overseas entities such those in Tencent's position:

Note: Where the Exchange believes that the jurisdiction in which the overseas issuer is incorporated is unable to provide standards of shareholder protection at least equivalent to those provided in Hong Kong, but that it is possible by means of varying the overseas issuer's constitutive documents to provide standards of shareholder protection equivalent to those provided in Hong Kong, then the Exchange may approve the listing of securities of the overseas issuer subject to the overseas issuer making such variations to its constitutive documents as the Exchange may require."

(HKEx, 2004b: 01)

Exhibit 2 of Appendix C provides a detailed description of the differences in shareholder protection rights between the BVI Act and Cayman Island Law. This exhibit includes possible alterations made by BVI-incorporated companies in order to comply with the provision to rule 19.05(1) as above.[87]

It is clear that at the time of the IPO process the above-mentioned regulations represented a source of risk to Tencent. Should the HKEx have invoked the provision to rule 19.05(1), this may have raised concerns for investors in terms of Tencent's shareholder protection policies. In addition, this could have led to delays in the IPO process, distorting Tencent's estimated timeline of events, and potentially affect overall investor demand.

There was a possibility that the HKEx could have refused Tencent the right to list on the exchange, regardless of the necessary amendments in accordance with the provision to rule 19.05(1) (see Appendix C, Exhibit 2). This would have led to further delays for Tencent's IPO as the company would have needed to list on an alternative, suitable exchange. Inevitably this could have affected market sentiment and the overall level of demand surrounding the IPO. While it is safe to assume that Tencent would likely have chosen the NASDAQ as an alternative measure, this too would have subjected the company to specific requirements and procedures which may also have led to further delays in launching the IPO.

[87] These differences and suggested alterations are materially consistent with the practices of the SEHK, rule 19.05 and the provision to rule 19.05 as per the HKEx Main Board listing rules in the 2004 year.

Note: The BVI Business Companies Act was implemented in 2004, shortly after the IPO. This Act addressed all concerns regarding minority shareholder protection as outlined by the HKEx. The aim of this act was to align generally accepted international guidelines on minority shareholder protection with existing BVI-policies (Ogier, 2009: 01).

5.3 HKEx vs NASDAQ: Comparing the Cost of Listing

The analysis to follow accounts for the fee structures of the HKEx Main Board and the NASDAQ National Market at the time of Tencent's IPO. Fees are calculated based upon the midpoint of the offer price range, being HK$3.235 per offer share. This is because the actual offer price of HK$3.70 was not confirmed by the time Tencent made its decision to list on the HKEx.

The following calculations are based on the initial listing fees and annual listing fees outlined in the listing rules and regulations of each respective exchange.

The NASDAQ National Market data was retrieved from the 2003 'NASDAQ Rule 4000 Series' (SEC, 2003: 101 - 111). This series of rules and regulations remained effective until July 2006, upon which the NASDAQ Stock Market restructured its market tiers by introducing the NASDAQ Global Select Market (NASDAQ, 2014: 01).

Research indicates that the applicable sections of the HKEx Main Board initial listing fees and annual listing fees have remained unchanged (HKEx, 2014a). While the HKEx began making amendments to the Main Board listing rules as at 31 March 2004, all amendments have not affected the amounts charged by the HKEx Main Board for its initial listing fees and annual listing fees. All amendments affecting the fee structure of the HKEx were specific to equity instruments and scenarios that were neither applicable nor material to Tencent's IPO decision and the associated listing fees (HKEx, 2008a; 2008b; 2009a; 2014b).

These total fees have been calculated both exclusive of the over-allotment option and inclusive of the over-allotment option.

Table 5.2: Actual HKEx Main Board Listing Fee Structure and Estimated NASDAQ National Market Listing Fee Structure to be Paid by Tencent Upon Listing

	Exclusive of the Over-Allotment Option (Midpoint Offer Price of HK$3.235 per Share)		Inclusive of the Over-Allotment Option (Midpoint Offer Price of HK$3.235 per Share)	
	HKEX Main Board (HK$)	**NASDAQ National Market (HK$)**	**HKEX Main Board (HK$)**	**NASDAQ National Market (HK$)**
Equity Market Listing Fee	400 000	1 169 685	450 000	1 169 685
Annual Exchange Fee	449 000	584 843	541 000	584 843
Non-Refundable Application Fee	n/a	38 990	n/a	38 990
Assessment Fee	n/a	n/a	n/a	n/a
	849 000	**1 793 518**	**991 000**	**1 793 518**
Note	For the purpose of comparison and uniformity, all NASDAQ-related fees have been converted from United States Dollars (US$) into Hong Kong Dollars (HK$) at the prevailing exchange rate as at Tencent's HKEx listing date, 16 June 2004. On this date US$1 equated to HK$7,7979.			

Table 5.2 together with Exhibit 3 of Appendix C show that both exchanges charged IPO firms an initial equity market listing fee as well as an annual exchange fee. The NASDAQ charged listing applicants an additional non-refundable HK$38,990 (US$5,000) application fee, while neither exchange charged listing applicants an assessment fee.

5.3.1 Exclusive of the Over-Allotment Shares

Table 5.2 shows that Tencent would have paid a total of HK$849,000 to list on the HKEx Main Board assuming that its offer shares were priced at the midpoint of the offer price range, and that the over-allotment option was not exercised. Accounting for the initial 420,160,500 offer shares, this ensured that the total value of the equities listed approximated to (420,160,500 offer shares x HK$3.235 per share) HK$1,359,219,218. Applying this amount to the fee tables in Exhibit 3 of Appendix C, it is clear that this amount can be categorized in the ‘not exceeding – 1,500 million’ category in relation to the HKEx equity market listing fees. Therefore, the corresponding initial fee that Tencent would have had to pay was HK$400,000. Applying this to the HKEx’s annual exchange listing fees, it is clear from Exhibit 3 of Appendix C that the value of Tencent’s offer shares could be categorized under the ‘not exceeding – 1,500 million’ category. Therefore, the corresponding annual fee to be paid by Tencent was HK$449,000.

Table 5.2 shows that Tencent would pay a total of HK$1,793,518 (US$230,000) to list on the NASDAQ National Market assuming that its offer shares were priced at the midpoint of the offer price range, and that the over-allotment option was not exercised. In terms of the NASDAQ National Market, there were fewer thresholds applied in the fee calculation. However, IPO firms would incur a non-refundable application fee of HK$38,990 (US$5,000) over and above the equity market listing fee and annual listing fees.[88]

Considering the volume of Tencent's offer shares, it would have been categorized in the 'over 50 million shares' category with respect to the NASDAQ's equity market listing fees. This translated into a total cost of HK$1,169,685 (US$150,000) at the time.[89] In terms of the annual listing fee, Tencent's total number of shares outstanding superseded the NASDAQ's top tier of one hundred million shares. This meant that the company would have been categorized in the 'over 100 million shares' category as per Exhibit 3 of Appendix C, and would have paid an annual listing fee of HK$584,843 (US$75,000).[90]

5.3.2 Inclusive of the Over-Allotment Shares

Taking the additional 63,024,000 over-allotment shares into consideration, this increased the total amount of offer shares to 483,184,500. This meant that the total value of the equities listed would approximate to (483,184,500 offer shares x HK$3.235 per share) HK$1,563,101,858.

Table 5.2 shows that Tencent would have had to pay a total of HK$991,000 to list on the HKEx Main Board assuming that its offer shares were priced at the midpoint of the offer price range, and that the over-allotment option was exercised. By including the over-allotment option, this increased the total value of the equities to be listed by approximately 15%. Applying this to the HKEx Main Board equity market listing fee tables in Exhibit 3 of Appendix C, this changed the categorization of Tencent's offer shares and increased its listing costs. Resultantly Tencent would have been categorized in the 'not exceeding- 2,000 million' category and would have paid an initial equity market listing fee of HK$450,000. This was 12.5% higher than the HK$400,000

[88] On 16 June 2004 US$ 1 equated to HK$ 7, 7979. Therefore, US$5,000 x HK$7, 7979 = HK$ 38,990.
[89] On 16 June 2004 US$ 1 equated to HK$ 7,7979. Therefore, US$150,000 x HK$7, 794789 = HK$ 1,169,685..
[90] On 16 June 2004 US$ 1 equated to HK$ 7, 7979. Therefore, US$75,000 x HK$7, 7979 = HK$ 584,843.

equity market listing fee achieved without accounting for the over-allotment option. The same scenario applied when determining the HKEx annual listing fee. Table 5.2 shows that the over-allotment option increased the HKEx annual listing fee by 20.49% from HK$449,000 to HK$541,000.

Inclusive of the over-allotment option, the total fees payable by Tencent to list on the NASDAQ National Market were HK$1,793,518 (US$230,000). This was inclusive of the HK$38,990 (US$5,000) non-refundable application fee.

Exhibit 3 of Appendix C shows that the vast difference in fees charged by the respective exchanges was directly related to the classification systems used. The NASDAQ's simplistic classification system was based on the number of shares made available, as opposed to the HKEx which used a comprehensive tier system based on the value of the equities listed. Tencent's original 420,160,500 available offer shares showed that regardless of the over-allotment option the company would still have been classified in the top tier of the NASDAQ's equity market listing fee and annual exchange fee structures. Therefore, the NASDAQ equity market listing fee would remain at a total cost of HK$1,169,685 (US$150,000) while the annual listing fee would remain at HK$584,843 (US$75,000) as well.

Accounting for the fee structures and associated scenarios above, it is clear that the collective listing fees charged by the HKEx Main Board were 80.98% to 111.25% lower than the total listing fees charged by the NASDAQ National Market. This shows that it was costly for Tencent to list on the NASDAQ National Market and indicates that as a strategic consideration, this would have played a large role in Tencent's listing decision. However, listing fees are not the predominant factor when choosing an exchange. Therefore, one needs to assess other regulatory factors to understand Tencent's rationale behind listing on the HKEx Main Board.

5.4 US GAAP and the Sarbanes-Oxley Act of 2002

5.4.1 US GAAP

Up until 15 November 2007, the NASDAQ did not allow IPO applicants to prepare their financial statements according to the International Financial Reporting Standards (IFRS). Previously, all NASDAQ IPO applicants were to reconcile its financial statements prepared under IFRS with US GAAP (Generally Accepted Accounting Principles) (NASDAQ, 2007:1). As mentioned in Section 4.8, should Tencent have applied to list on the NASDAQ National Market it would have had to comply with US GAAP accounting standards.

The likes of the British Virgin Islands (BVI), Cayman Islands and Hong Kong have adopted IFRS as their primary standard to prepare financial statements (PWC, 2013: 8, 12, 158).[91] This suggests that Tencent would have needed to re-prepare all of its audited financial statements to account for US GAAP if it was to list on the NASDAQ. This would have presented a problem with respect to both cost, and time delay.

Should Tencent have elected to follow-through with a decision to list on the NASDAQ, the associated costs to re-prepare its financial statements according to US GAAP accounting standards would have exacerbated listing costs. This would have increased Tencent's 80.98% to 111.25% HKEx cost-saving differential even further. A considerable time delay in redrafting the statements would also slow down the overall IPO process. At a time when technology IPOs were traditionally rebounding from a 3-year downturn (resulting from the 2000 Dotcom crash), this could have had a considerable effect on the potential demand for Tencent shares at the time (Schwartz & Stephens, 2006).

5.4.2 Sarbanes-Oxley Act of 2002 (SOX)

The Sarbanes-Oxley Act was signed into United States law on 30 July 2002 (SEC, 2002: 01). A

[91] In general Hong Kong companies are to prepare financial statements under local GAAP, Hong Kong Financial Reporting Standards (HKFRS). However, these have been converged with IFRS and there are/were no significant differences in accounting policy between IFRS and HKFRS in preparing Tencent's financial statements.

response to the white-collar crimes of multinational corporations (MNCs) in the late 90's, this US legislation created stringent requirements for businesses in the areas of corporate governance, financial disclosure and public accounting practices.

As a result, all companies that applied to list or were currently listed in the USA would have needed to comply with these regulations. Tencent would have had to follow suit in order to be eligible to list on the NASDAQ. In light of this, Tencent's readiness to comply with the Sarbanes-Oxley Act could have had a significant impact on the timing of its IPO in the market and the valuation received (PWC, 2004: 17). Compliance with the applicable sections in the Act would have been a laborious task likely to delay its IPO process.

Law firm 'Foley & Lardner' suggested that for companies generating revenues under $1 billion, the average annual cost of going public in accordance with Sarbanes-Oxley Act in 2004 had increased by 123.1% from US$1.3 million to US$2.9 million (Schwartz & Stephens, 2006). It is evident from Exhibit 2 of Appendix D that Tencent had consistently achieved revenues under US$1 billion between 2001 and 2003.[92] This suggested that it would have cost Tencent an additional HK$226,182,60 in order to be Sarbanes-Oxley compliant.[93]

Over and above the cost, should Tencent not have adequately met the requirements of the Sarbanes-Oxley Act, there could have been a lack of investment from potential investors as well as a lack of underwriter enthusiasm resulting from this added risk.

Note: While the Sarbanes-Oxley Act did address specific regulatory requirements, there was some overlapping with the general listing requirements of the NASDAQ and other US-based exchanges.

[92] Tencent's highest revenue achieved during the 2001 to 2003 period was 734,957,000 RMB. At the average 2003 US$ to HK$ conversion rate of 8.2770 RMB to US$ 1, this translate to (734,957,000 RMB / 8.2770 RMB) = US$ 88,795,095.
[93] US$2.9 million x HK$7.7994 = HK$226, 182, 60.

5.5 Conclusion

It is clear from the above that there were various factors that Tencent's management would have had to consider in deciding on its exchange of choice. While the HKEx Main Board listing fees were 80.98% to 111.25% cheaper than the NASDAQ National Market, listing fees are one of many factors to consider when choosing an exchange (EY, 2013:14). The regulatory complications of US GAAP accounting policies and the Sarbanes-Oxley Act of 2002 encouraged additional costs for Tencent and potential time delays that would have affected both the company valuation and resultant demand of Tencent shares.

Thus, it was evident that as a Chinese internet firm with extensive operations in the PRC, Tencent was already well suited to list on the HKEx. Not only was it cost-effective, but there was a clear connection between the HKEx and Tencent's business. This was attributable to the likes of the relevant listing and statutory regulations, a language and cultural link and the sheer popularity of Tencent and the QQ brand within Hong Kong and the PRC.

These factors ensured that the HKEx listing process was financially feasible and timeously executed, reducing the overall risks that Tencent would have faced if it had chosen to list on the NASDAQ at that time.

Chapter 6: A Complex Valuation of the Tencent IPO

Note: As a case study, this chapter is written from the perspective of an outside investor valuing Tencent on 16 June 2004. It is written in the present tense because it is forward-looking from a point in time during the 2004 year *leading up to* its IPO listing date.

This valuation is based solely on company information available as at 16 June 2004. No other information has been reviewed, considered or incorporated into these valuation models whatsoever. This guarantees that the following chapter is unbiased and uninfluenced by any post-IPO company events or material that may affect or influence one's judegment.

The following chapter provides a valuation of Tencent Holdings Limited as at its IPO listing date. The purpose of this valuation is to establish, based on the case information, whether the IPO was fairly priced in accordance with Tencent's intrinsic value at the time of listing. In doing so, this provides insight into the true value of Tencent's offer shares and the likelihood occurrence of potential IPO underpricing.

This valuation has been conducted in accordance with the relative/multiples approach, and the unlevered FCFF (Free Cash Flow to the Firm) discounted cash flow (DCF) approach. The two valuation methods complement each other in achieving the most accurate assessment of the IPO's intrinsic share value. The DCF valuation ensures that through assessing Tencent's cash flows, growth and risk characteristics it achieves the best estimated intrinsic value of the IPO shares.

By comparing Tencent to its competitors on a variety of factors, it is possible to establish which competitor best replicates Tencent as a company. By calculating appropriate valuation metrics

for the proxy company and adjusting these for Tencent's firm-specific risk and growth factors, this relative valuation approach ensures that a suitable range in share prices can be established for Tencent.

As Tencent was a private company prior to its IPO, certain market variables required under the DCF approach cannot be obtained, leaving the model incomplete. Once this suitable proxy company has been established, the relevant market-related variables can be substituted into the DCF valuation model for Tencent. This estimated intrinsic value can then be interpreted together with the price range determined under the relative valuation model.

6.1 Relative Valuation: A Comparison between Tencent Holdings Limited and its Industry Competitors

All companies within the competitor portfolio have financial years starting 1 January and ending 31 December of each year. Importantly, prior to 2002 SINA Corp's financial year-end was from 1 July to June 30. As of November 2002 its fiscal year-end was changed to 31 December. Upon this change, the associated 2002 financial results were restated and recompiled in accordance. This means that for comparative purposes all references to SINA Corp's 2001 financial results are in accordance to a financial year-end of 30 June and not 31 December as per the 2002 and 2003 fiscal year-ends.

Despite Tencent's market position within the Chinese internet space, it faces strong industry competition from SINA Corp, Sohu.com, NetEase and TOM Online (see Section 4.5). The following section provides a comparison of Tencent and each of these competitors across a range of characteristics with the goal of establishing the most suitable competitor(s) from which to compute a relative valuation for the company.

For a detailed summary of the background and history of each of these competitors, please see Appendix D, Exhibit 1.

In order to account for any exchange rate differences between Tencent and its industry peers, all data quoted as Chinese Renminbi has been converted to US Dollars.[94] As Tencent's competitors are listed on the NASDAQ, it is a pre-requisite of the exchange for their financial statements to be quoted in US Dollars. Therefore, for comparable purposes all financial statements have been adjusted to reflect these amounts in US Dollars.

6.1.1 Operating Segments

Although Tencent has four operating segments, its three primary operating segments are MVAS, IVAS and online advertising. With inter-related product and service offerings, these effectively leverage each operating segment's market position by creating and influencing market demand.

6.1.1.1 Mobile & Telecommunications Value-Added Services (MVAS)

The core of this operating segment is Tencent's Mobile QQ offering. In addition, this operating segment provides mobile chat services, interactive voice response (IVR) services, ringback tones, mobile music download services, picture download services, mobile news and information content services as well as mobile games.

6.1.1.2 Internet Value-Added Services (IVAS)

Tencent's IM services are the core of its IVAS operating segment. These IM services comprise of three primary offerings, namely Basic QQ, Premium QQ and Tencent Messenger (see Section 4.5.1). In addition, Tencent also offers QQ Mail, a supplementary email service integrated with the QQ platform. Furthermore, the IVAS segment provides community services through offerings such as the QQ.com Portal, QQ Dating, QQ Alumni Club and QQ E-card. This also includes entertainment services such as casual games, QQ Show (avatars) and MMORPG games.

[94] Tencent's financial results for the 2001 to 2003 period were converted at the relevant World Bank nominal exchange rates for the US dollar to the Chinese Renminbi. This equated to the following ratios:

2001 – US$1 = 8.2771 RMB
2002 – US$1 = 8.2770 RMB
2003 – US$1 = 8.2770 RMB

6.1.1.3 Online Advertising Services

Based on the information in Section 4.5.4, Tencent advertises via its PC-based QQ IM offering and continues to increase advertising efforts on its QQ.com web portal.

The PC-based QQ IM service provides an attractive and unique advertising platform for Tencent's clients. Namely, this is because it uses log-in flashes and system messages to differentiate itself from other online advertising entities.

The concept of a log-in flash is that when QQ users login to the QQ network a targeted high-resolution advert will appear for a limited time period (Tencent Prospectus, 2004: 88). The user will have to wait for the time period to elapse before they are able to use the QQ network. System messages are advertising messages that are sent-out to all QQ users at the same time. QQ will send a user-targeted IM message from its server to all active QQ users based on collected user data. This message, usually in picture format, gives the user the opportunity to click on the image to learn more about the product or service on offer (Tencent Prospectus, 2004: 88).

6.1.1.4 Other Services

These include Tencent's RTX Enterprise IM service offering (see Section 4.1.4) as well as trademark licensing revenues from co-branded QQ products, Q-Gen products and retail shows.

These products are distributed through a national chain of over 199 Q-Gen stores throughout the PRC.

Table 6.1: Comparison of the Product and Service Offerings between the Operating Segments of Tencent and its Four Main Competitors

	Tencent Holdings Ltd	SINA Corp	Sohu.com	NetEase	TOM Online
Internet Value-Added Services (IVAS)					
IM services	✓	X	✓	✓	X
Email services (QQ Mail)	✓	✓	✓	✓	✓
Community Services					
Web Portal (QQ.com)	✓	✓	✓	✓	✓
Online Dating (QQ Dating)	✓	✓	✓	✓	X
Alumni Club (QQ Alumni Club)	✓	X	✓	✓	X
E-Card services (QQ E-Card)	✓	X	✓	✓	X
Entertainment Services					
Casual Games	✓	✓	✓	✓	X
Digital Avatars (QQ Show)	✓	X	X	X	X
MMOG Games	✓	✓	✓	✓	X
Mobile and Telecommuncations Value-Added Services (MVAS)					
Mobile IM (Mobile QQ)	✓	X	X	X	X
Mobile Chat Services	✓	✓	✓	✓	✓
IVR Services	✓	✓	✓	✓	✓
Ringback Tones	✓	✓	✓	✓	✓
Mobile Music & Picture Download Services	✓	✓	✓	✓	✓
Mobile News and Information Content Services	✓	✓	✓	✓	✓
Mobile Games	✓	✓	✓	X	X
Online Advertising Services	✓	✓	✓	✓	✓
Other Servies					
Enterprise IM Services (RTX)	✓	X	X	X	X
Product and Brand Licensing	✓	X	X	X	X
Overall Percentage Match (%)		63.16%	**78.95%**	73.68%	42.11%

As per Table 6.1 above, it is evident that Sohu.com resembles Tencent the most with regards to its product and service offerings, while NetEase does so to a slightly lesser extent and SINA Corp and TOM Online much less so.

While Table 6.1 shows the correlation between Tencent and Sohu.com's product and services, there are distinct differences in the range and depth of each entity's offerings.

Tencent's primary offering, its IM services are unmatched by its respective competitors. While Sohu.com offers its SOQ IM service, the platform was only publicly released in the fourth quarter of the 2003 financial year (Sohu.com, 2003: 07). As an offering in its infancy stage it is

clear that Tencent's QQ offerings are vastly superior in terms of popularity and overall functionality. As a PC-only IM platform SOQ proves that Sohu.com's IM product offerings are not on par with Tencent. While Tencent offers Mobile QQ, there are no other vast differences between each company's MVAS offerings.

In terms of the respective email services offered, Sohu.com charges its users a once-off registration fee as well as a monthly subscription fee granting mobile email access. Compared to Tencent's free QQ Mail service this highlights a further area of difference between the two company's' product and service offerings.

Sohu.com emphasizes focus on its web portal, providing central access to the likes of community services and entertainment services similar to Tencent. Sohu.com's web portal contains greater amounts of content than Tencent's QQ.com, focusing largely on its unique online directory, search engine and e-commerce offerings. Collectively, Sohu.com's web portal has generated greater total online advertising revenues than Tencent.

When analyzing these differences in terms of the revenue-generating properties of each company, there is little difference between Tencent and Sohu.com. Where Sohu.com generates e-subscriptions and e-commerce revenues, Tencent benefits from premium IM services, RTX system and licensing agreements. However, when taking Tencent's Mobile QQ and QQ Premium services into consideration, it is clear that Tencent's product and service offerings are stronger.

6.1.2 Place of Incorporation

Although incorporated in the Cayman Islands, Tencent has two principal places of business - Admiralty, Hong Kong and its headquarters in Shenzhen, PRC. In terms of Tencent's competitors, it is important to account for their place of incorporation, headquarters location and the geographic segmentation of each competitor's operations. In this context, it is evident from Exhibit 1 of Appendix D that Tencent and all respective competitors are incorporated in the Cayman Islands, yet operate in the PRC (for a detailed explanation, see Section 5.2.2).

6.1.3 Creating Opportunities for International Expansion

Tencent's primary operations are in Hong Kong and Mainland China. Prior to the IPO Tencent has positioned itself for potential future expansion into the United States, South Africa and the rest of Asia.

It did so by registering the QQ mark and the penguin logo in Hong Kong, Taiwan and Japan, while filing associated trademark applications in Singapore, Thailand, Indonesia, South Korea, South Africa and the United States (Tencent Prospectus, 2004: 94).It also filed additional trademark applications in Taiwan and Japan.

While it is common for a company to exercise appropriate measures in order to secure its intellectual property, the relevant patent applications in the respective foreign countries hint at potential market expansion in future. By filing over 30 patent applications in the PRC and the United States alone, it appears that Tencent recognizes the potential threat posed by its competitors in the PRC and North American internet space. Therefore Tencent has taken the necessary legal and precautionary measures to both protect and diversify its market position.

Naspers's (previously MIH) 46.5% ownership stake in Tencent has provided an effective opportunity for both parties to benefit from relevant licensing and cooperation agreements in untapped market spaces. This has ensured the potential for Tencent to penetrate into previously untapped markets in Indonesia, Thailand, Greece, Cyprus and South Africa. In addition, Naspers has used Tencent's services to leverage the product offerings of its affiliate companies, namely Mweb Thailand Limited (Mweb Thailand). Mweb Thailand agreed to pay Tencent 3 Baht per SMS message and 4.50 Baht per MMS message to use any of Tencent's licensed downloadable images (Tencent Prospectus, 2004: 133).

The only company amongst Tencent's competitors to internationally expand its operations is SINA Corp. SINA Corp operates in a diverse portfolio of countries, namely China, Hong Kong, Taiwan and the United States. However, SINA Corp focusses its efforts on specifically targeting Chinese individuals living in these countries, and not on the general population.

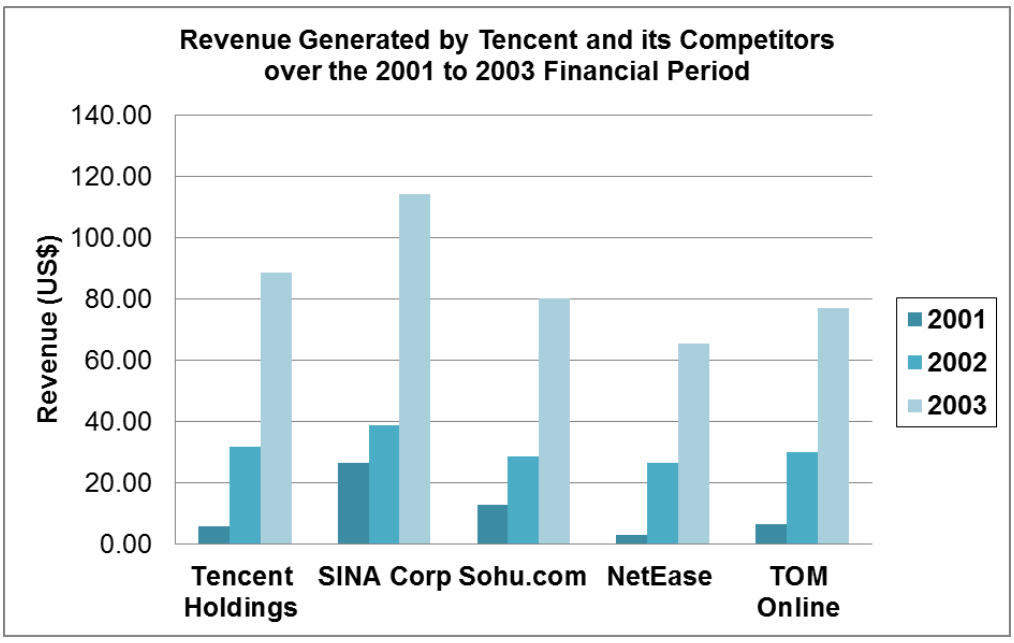
Sohu.com, NetEase and TOM Online operate in the PRC and Hong Kong only.

However, of these companies, Sohu.com is the only one to expand its patent and trademark applications abroad. Specifically, Sohu.com registered three service marks in the United States, filed a service mark application in Taiwan and was in the process of applying for registration in Malaysia and Singapore.[95]

While international trademark and patent applications are not fully conclusive evidence of a company's international expansion plans, they are integral in providing a company the opportunity to do so properly. Taking this into consideration, the activities of SINA Corp and Sohu.com surrounding this notion are most comparable to Tencent. While Tencent and Sohu.com may not act on these patents and trademarks, they reserve the right for these companies to enter into these markets and/or protect the abuse of its intellectual property.

6.1.4 Revenues

Figure 6.1:



[95] Sohu. 2003b. *Sohu Annual Report 2003*. Available: http://files.shareholder.com/downloads/ABEA-4Z99DA/3131732366x0x662302/1B6ADA5A-25A6-4D51-ADFF-D665C74CC6AE/2003_Annual_Report.pdf [2014, April 16].

It is observable from Figure 6.1 that during the 2001 to 2003 period, SINA Corp consistently generated year-on-year revenues exceeding all other industry competitors.

Table 6.2: Revenue Differential between Tencent and its Four Main Competitors over the 2001 to 2003 Financial Period

	SINA Corp	Sohu.com	NetEase	TOM Online
2001	350.0%	119.3%	-42.4%	8.5%
2002	22.4%	-9.6%	-11.6%	-5.7%
2003	28.7%	-9.4%	-22.6%	-13.2%

Key	
-	**Tencent's Revenues > Competitors by x%**
+	**Tencent's Revenues < Competitors by x%**

Contrasting this with Tencent's revenues over this period, Table 6.2 shows that the difference between the two company's revenues translates into a range of deviations of between 22.3% and 349.9%. The figures and tables show that in terms of revenue, Sohu.com and TOM Online closely resemble Tencent. On a comparable basis Sohu.com and TOM Online's past and most recent revenue performance follow a similar trend.

Table 6.3: Revenue Comparison Chart – Tencent and its Four Main Competitors

			(US$'000)
	2001	**2002**	**2003**
Tencent Holdings (US$)	5 929	31 788	88 795
Year-on-Year Revenue Growth (%)		436.14%	179.33%
Compound Annual Growth Rate (CAGR)			286.99%
SINA Corp Revenue (US$)	26 683	38 894	114 285
Year-on-Year Revenue Growth (%)		45.76%	193.84%
Compound Annual Growth Rate (CAGR)			106.96%
Sohu.com (US$)	13 000	28 729	80 425
Year-on-Year Revenue Growth (%)		120.99%	179.94%
Compound Annual Growth Rate (CAGR)			148.73%
NetEase (US$)	3 417	28 088	68 758
Year-on-Year Revenue Growth (%)		722.01%	144.79%
Compound Annual Growth Rate (CAGR)			348.58%
TOM Online (US$)	6 433	29 975	77 073
Year-on-Year Revenue Growth (%)		365.96%	157.12%
Compound Annual Growth Rate (CAGR)			246.13%

Table 6.3 shows that over time Sohu.com better replicated Tencent's revenues. This was because Sohu.com's 2003 revenues were 9.4% smaller than Tencent's as opposed to TOM Online's, which were 13.2% smaller.

The 2003 financial year is the best indicator of Tencent's most recent financial performance. This means that a larger weighting has been placed on this factor when assessing which competitor best replicates Tencent on the basis of revenues.

Therefore, the similarities in revenue growth patterns and the reduced revenue differential between Tencent and both Sohu.com and TOM Online suggests that both competitors are most comparable to Tencent on the basis of revenues.

6.1.5 Gross Margins

Figure 6.2:

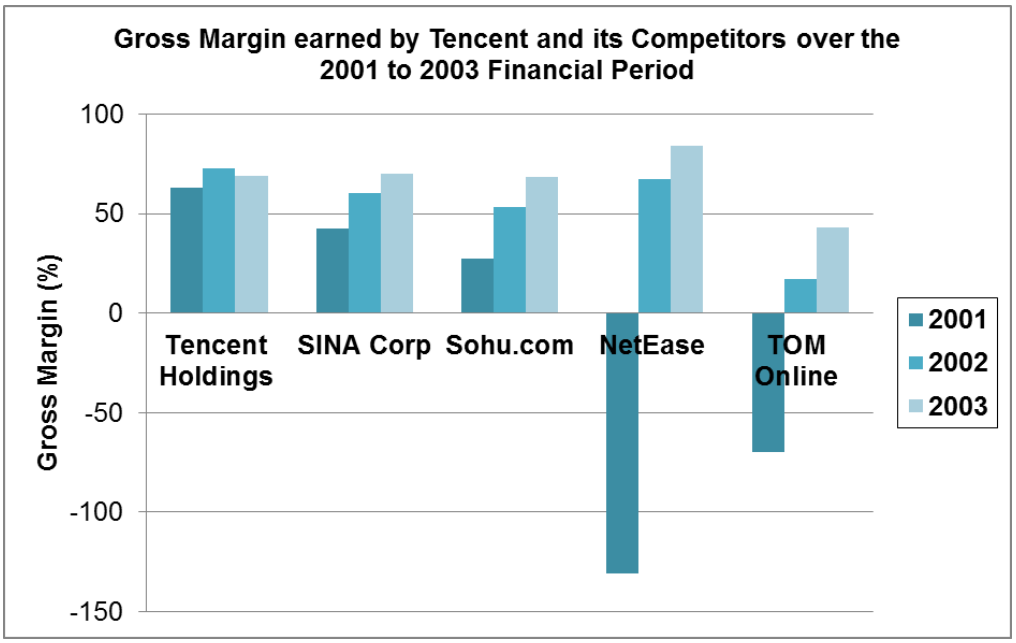


Figure 6.2 shows that over the 2001 to 2002 financial period Tencent earned gross margins that outperformed its industry peers. In the 2003 financial year Tencent was the only company to experience a decline in its gross margins when compared with previous years.

Table 6.4: Summary of Gross Margins earned by Tencent and its Competitors over the 2001 to 2003 Financial Period

	2001	2002	2003
Tencent Holdings	63.23%	72.76%	68.77%
% Change	-	9.5%	-4.0%
SINA Corp	42.46%	60.12%	69.87%
% Change	-	17.7%	9.8%
Sohu.com	27.59%	53.27%	68.66%
% Change	-	25.7%	15.4%
NetEase	-130.79%	67.56%	84.24%
% Change	-	198.4%	16.7%
TOM Online	-69.56%	17.02%	42.80%
% Change	-	86.6%	25.8%

Table 6.4 suggests that the ability of both Sohu.com and SINA Corp to retain a percentage of each dollar per sale was approximately equivalent to Tencent in the 2003 financial year. SINA Corp and Sohu.com earned an almost identical gross margin to Tencent. Sohu.com's 68.77% margin was the closest approximation to Tencent's in the 2003 year, while SINA Corp's 69.87% was 1.1% higher.

Taking this into consideration, it would appear that both Sohu.com and SINA Corp are the most comparable competitors to Tencent on this basis.

6.1.6 Total Asset Structure

Figure 6.3:

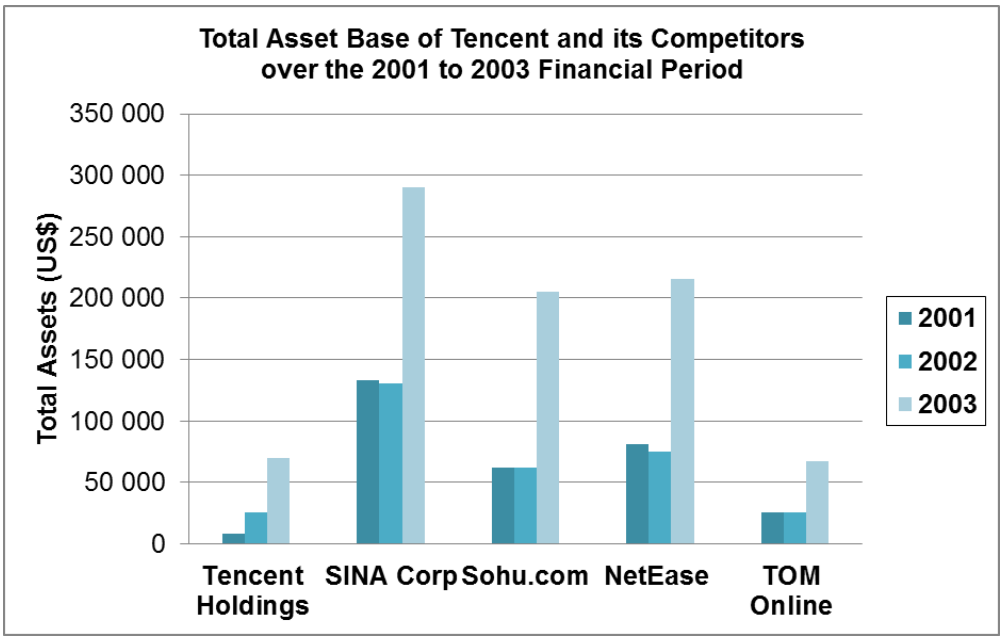


Figure 6.3 shows that Tencent had the smallest asset base amongst its competitors in the 2001 to 2003 financial period. On the contrary, Tencent posted the largest growth in total assets over this period, generating a CAGR of 196.4%.[96]

[96] CAGR of Tencent's Total Assets for 2001 to 2003: [(69 556 / 7 918)^(1/2) – 1) x 100] = 196.39%

Table 6.5: Summary of the Total Asset Base of Tencent and its Competitors over the 2001 to 2003 Financial Period

			(US$'000)
	2001	**2002**	**2003**
Tencent Holdings	7 918	25 814	69 556
% Growth	-	226%	169%
SINA Corp	133 122	130 479	289 897
% Growth	-	-2%	122%
Sohu.com	61 958	61 972	205 055
% Growth	-	0.02%	231%
NetEase	81 530	74 840	215 870
% Growth	-	-8%	188%
TOM Online	25 626	25 574	67 376
% Growth	-	-0.2%	163%

TOM Online's asset base is the most comparable to Tencent. The size of both company's asset base was approximately similar over the 2002 and 2003 financial years. While Table 6.5 shows that TOM Online's asset base was larger in the 2001 financial year, the overall trend in growth and size is the most comparable to Tencent in this three-year period.

Based on the similarities in the total asset structure of TOM Online and Tencent, TOM Online is the most comparable competitor to Tencent in this regard.

6.1.7 Net Profit / (Loss) Generated

Figure 6.4:

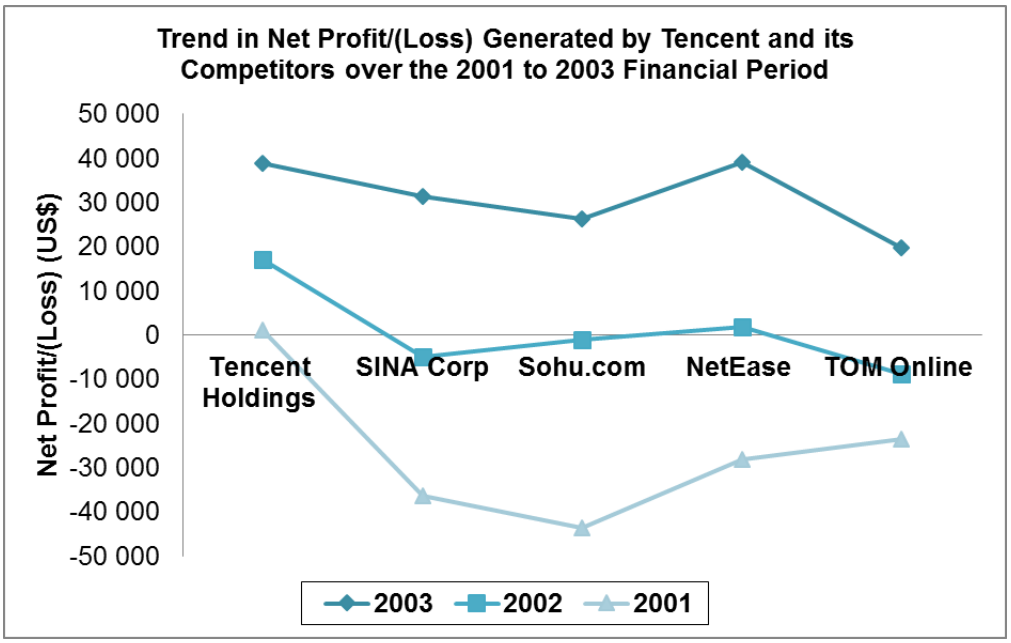
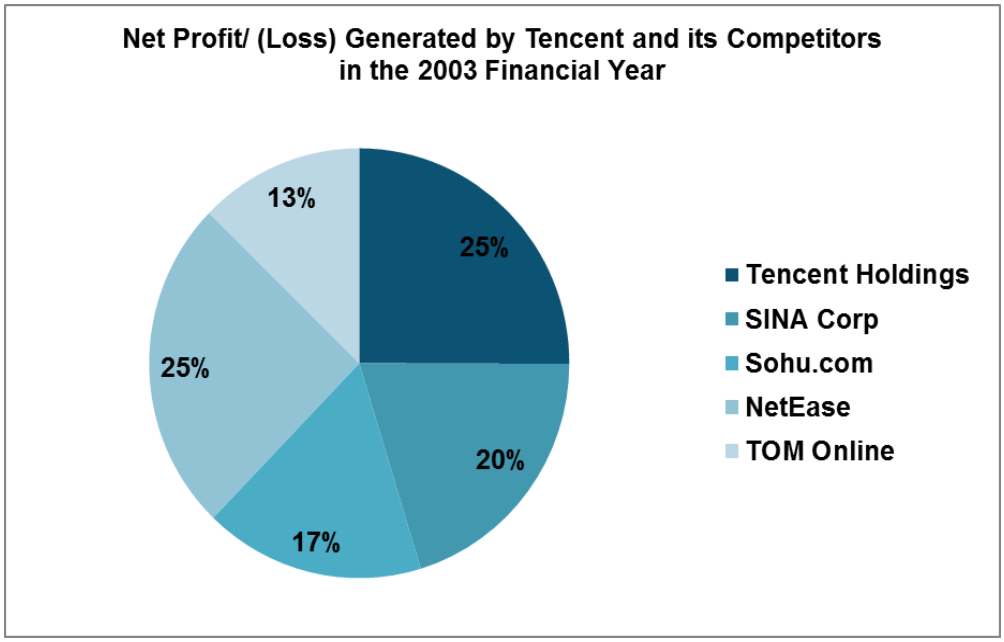


Figure 6.4 shows that Tencent was the only company amongst its competitors to consistently generate a net profit over the 2001 to 2003 financial period. Hence, Figure 6.4 shows that Tencent was the only company to post results in the profitable region above the x-axis.

Figure 6.5:



The 2003 year was an economically prosperous time for the entire value-added service industry, with all companies posting strong net profit results. Figure 6.5 shows that at this time, both NetEase and Tencent represented the largest portion of the market, generating 25% of total industry net profits in that year.

Table 6.6:

			(US$'000)
	2001	**2002**	**2003**
Tencent Holdings	1 234	17 000	38 927
% Change	-	1278%	129%
SINA Corp	(36 351)	(4 949)	31 423
% Change	-	-86%	-735%
Sohu.com	(43 587)	(1 036)	26 357
% Change	-	-98%	-2644%
NetEase	(28 173)	1 966	39 010
% Change	-	-107%	1884%
TOM Online	(23 438)	(8 743)	19 699
% Change	-	-63%	-325%

While Tencent's competitors reduced their net losses over the 2002 year, NetEase was the first company to achieve a net profit over this three-year period. This being said, the largest reduction in overall company losses was posted by Sohu.com. Table 6.6 shows that Sohu.com reduced its losses by 98% over the 2002 year alone.

Accounting for the above, this data proves that over the three-year period there was no competing company that was directly comparable to Tencent's net profit trend. While NetEase's financial performance improved considerably, it followed the same growth trend as SINA Corp, Sohu.com and TOM Online over this period. Therefore, there is no correlation amongst Tencent and its competitors in term of net profit performance over the 2001 to 2003 financial period.

6.1.8 Conclusion

Table 6.7: Summary of Comparable Factor Correlation between Tencent and its Four Main Competitors

	SINA Corp	Sohu.com	NetEase	TOM Online
Operating Segments	X	✓	X	X
Place of Incorporation	✓	✓	✓	✓
Creating Opportunites for International Expansion	✓	✓	X	X
Revenues	X	✓	X	✓
Gross Margins	✓	✓	X	X
Asset Structure	X	X	X	✓
Net Profit / (Loss)	No Correalation	No Correalation	No Correalation	No Correalation
Overall Percentage Match (%)	42.9%	**71.4%**	14.3%	42.9%

Table 6.7 summarizes the relative comparisons drawn between Tencent and its competitors. Based on these results it is clear that overall Sohu.com correlates with 71.4% of Tencent on the assessed factors. Therefore Sohu.com will be used as the comparison company in the multiples analysis of Section 6.2.

6.2 Relative Valuation: Multiples Analysis of Sohu.com

The following section provides a multiples analysis of Tencent using Sohu.com as a suitable proxy company.

A relative valuation values a company based on similar companies within industry. However, while companies may feature in the same competitor pool, there are numerous factors that make them different from one another. By converting the comparable company's financials into multiples this creates a commonality between both the target and comparable company. This provides a suitable basis for comparison.

By adjusting these standardized multiples for the differences in growth and risk factors between the two companies, this ensures that one can deduce an estimated intrinsic value of the IPO in relation to the market value of similar companies at that time.

6.2.1 Choice of Valuation Multiples

In order to generate proxy valuation multiples for the valuation of Tencent, adjustments will be made to the price-to-earnings (P/E) ratio and price-to-sales (P/S) ratio of the proxy firm (Sohu.com). This is to account for the differing risk and growth factors between it and Tencent. Internet companies are known to generate negative earnings for an extended period during their startup phase. Given that negative P/E ratios are meaningless, it has been suggested that P/S ratios are more appropriate for the valuation of such firms as sales are obviously always a positive number (Ho, Kim and Liao, 2011: 02).

However, considering Tencent posted three consecutive years of positive earnings over the 2001 to 2003 financial period, both the P/E and P/S ratios have been considered in the analysis below.

Table 6.8: Multiples Adjustment for the Effect of Differing Risk and Growth Factors between Tencent and Sohu.com

	Sohu.com	
	P/E	P/S
Differences in Product and Service Portfolios	↑	↑
Differences in Market Share	↑	↑
Leverage	↑	–
Overall Growth Prospects	↑	↑

For the purposes of the relative valuation of Tencent, Sohu.com's multiples were adjusted up or down, in order to account for differences between the two companies. Table 6.8 summarizes the effect of these adjustments for the differences between Sohu.com and Tencent.

6.2.1.1 Differences in Product and Service Portfolios

As per Section 6.1.1, it is clear that Sohu.com's range of product and service offerings is smaller than Tencent's i.e. it is less comprehensive. As a result, Sohu.com's valuation metrics are adjusted upwards.

6.2.1.2 Differences in Market Share

Tencent's IM service is its primary revenue driver. Thus, it is the key offering to consider within the company's competitive environment. As per Section 4.5.1, Sohu.com is a new market entrant to the Chinese IM market space. Sohu.com introduced its PC-only SQQ IM service in the fourth quarter (Q4) of the 2003 financial year. Considering Tencent's 74.3% stranglehold on the industry, all valuation metrics are adjusted upwards to account for this.

6.2.1.3 Leverage

Tencent does not carry any form of long-term debt whatsoever. This is contrary to Sohu.com

which had US$90,000,000 (HK$701,811,000) of zero coupon convertible senior notes issued in a private placement to Merrill Lynch and Pierce, Fenner & Smith Incorporated (Sohu.com, 2003b: 37).

As a zero coupon debt instrument this means that Sohu.com does not incur an interest expense. There should also be no cash flow until maturity. However, this is an embedded option instrument, which means that the cash flow is not a certainty. No cash flow will be received by at the end of July 2023 if holders do not exercise the right for Sohu.com to repurchase all or a portion of the principal amount in 2007, 2013 and 2018 (Sohu.com, 2003b: 37).

Therefore, Sohu.com's valuation metrics are adjusted to reflect Tencent's debt-free capital structure.

6.2.1.4 Overall Growth Prospects

Tencent's market position coupled with its debt-free capital structure and expected use of IPO proceeds suggested that the company had effectively positioned itself to reap further growth.

Given past financial performance and future expectations, Tencent had greater industry growth prospects than Sohu.com. As a result, Sohu.com's valuation metrics have been adjusted upwards.

6.2.2 Magnitude of Adjustments

Table 6.9: Adjusted Sohu.com Valuation Multiples reflecting Tencent's Risk and Growth Characteristics

	Sohu.com	
	P/E	P/S
Unadjusted Multiple	**75.9**	**32.0**
Net Effect of Multiple Adjustments	**+2**	**+1.25**
Adjusted Multiple	**77.9**	**33.25**

Table 6.9 summarizes the overall effect of the different risk and growth adjustments on Sohu.com's valuation multiples.

On the basis of the factors in Section 6.2.1 the net effect on the valuation metrics is the following:

6.2.2.1 Price: Earnings (P/E) Ratio

Tencent's diverse and profitable product and service range together with its dominant position in the IM market space suggest that its earnings potential is greater than Sohu.com. Tencent's overall growth prospects and long-run growth potential is also greater than Sohu.com.

In assessing the leverage characteristics of both firms, Sohu.com's increased leverage has raised its exposure to systematic risk. As a zero coupon debt instrument, the majority of this systematic risk comprises of interest rate risk. Assuming that debt holders do not exercise their right to sell the shares back to Sohu.com, the debt instrument will only pay out the entire cash flow on maturity. This leaves the debt instrument exposed to volatile interest rate changes. Overall, this increases Sohu.com's required rate of return which reduces Sohu.com's P/E multiple.

The net effect of these adjustments for risk and growth translates into an upward adjustment of 2 to Sohu.com's P/E ratio.

6.2.2.2 Price: Sales (P/S) Ratio

Because the relationship between earnings growth and sales growth is not linear, different adjustments are made to Sohu.com's P/E and P/S multiplies. The same applies to the overall growth prospects and long-term growth potential of Tencent.

It cannot be deduced whether Sohu.com's increased leverage affects its P/S multiple. To be prudent, no adjustment has been made to its P/S multiple on the basis of this factor.

The net effect of these adjustments for risk and growth translates into an upward adjustment of 1.25 to Sohu.com's P/S ratio.

6.2.3 Calculations of Sohu.com and Tencent Holdings Limited's Multiples

Table 6.10: Tencent Share Price Relative to each Adjusted Valuation Multiple

	US$	HK$
P/E	2.40	18.72
P/S	1.85	14.40

Table 6.10 summarizes the results achieved from the calculations to follow. Sohu.com's adjusted valuation multiples (Tencent's proxy multiples) are multiplied by Tencent's most recent accounting data to determine the value per Tencent share on its IPO launch date.

6.2.3.1 Price: Earnings (P/E) Ratio

$$\frac{\text{Share Price}_{\textbf{Sohu.com}}}{\text{Earnings per Share}_{\textbf{Sohu.com}}}$$

(US$22.78 / US$0.30)

= 75.9

Adjusted Sohu.com P/E ratio (proxy for Tencent's P/E ratio) = 77.9

Therefore, 77.9 times x [0.085 x 0.362478]

= US$ 2.40 [97]

[97] Average RMB to USD exchange rate for the 01 January 2004 to 31 March 2004 period: (0.120877 + 0.120818 + 0.120783) = 0.362478

6.2.3.3 Price: Sales (P/S) Ratio

$$\frac{\text{Share Price}_{\textbf{Sohu.com}}}{\text{Sales per Share}_{\textbf{Sohu.com}}}$$

[US$22.78 / (US$25,935,000 / 36,377,836 shares)]

US$13 / (0.7129341064)

= 32.0

Adjusted Sohu.com P/S ratio (proxy for Tencent's P/S ratio) = 33.25
Therefore, 33.25 times x [(257,553,000 RMB / 1,680,641,260 shares) x 0.362478]
= US$ 1.85 [98]

6.2.4 Results

Table 6.11: Tencent's Share Price Range on the Date of Listing

Total Share Price Range (US$)	US$1.85 - US$2.40
Total Share Price Range (HK$)	HK$14.40 - US$18.72

Table 6.11 shows that Tencent's share price on its IPO listing date should be in the range of US$1.85 – US$2.40. Upon converting this US$ denominated range into the equivalent HK$ share price, this equates to a range of HK$14.40 - HK$18.72 per share.[99] This shows that there is a small spread in the share prices achieved.

[98] Average RMB to USD exchange rate for the 01 January 2004 to 31 March 2004 period:
(0.120877 + 0.120818 + 0.120783) = 0.362478

[99] This was converted in accordance with the HKD to USD exchange rate as at 16 June 2004. This equates to 1 HKD = 7.7979 USD.

There are serious complications in deriving a price range for Tencent's shares in the above manner, as the lack of uniformity between the financial performance and financial position of both the proxy company and the target company present the possibility for data loss. This means that specific business characteristics and prospects may be left unaccounted for, leaving the price range as a speculatory tool of assessment.

6.3 Discounted Cash Flow Valuation: Free Cash Flow to the Firm

A DCF valuation, based on a company's ability to generate future cash flows, estimates the intrinsic value of that company. This diverse, commonly used valuation technique is the most theoretically correct of all possible valuation tools. It is built on the concept that the value of a company is derived from value attached to the free cash flows attributable to that company's stakeholders.

The DCF model uses assumptions and forecasts about the company's future performance to infer a projection of its future free cash flows generated over the period of assessment. This is normally a five-year projection period, but in some cases is a ten-year period. The free cash flow projections are then discounted under the net present value (NPV) method using an appropriate discount rate. Typically this discount rate is the weighted average cost of capital (WACC). As a result, the future cash flows have been converted to represent an amount equivalent to the valuation date. A terminal value representing the value of the company at the end of the projection period is also calculated. This terminal value takes into account the forecasted stable terminal growth rate of the company after the five-year/ten-year period considered.

These amounts are then summed together to represent the company's enterprise value. This represents the total collective value of the company's debt and equity. To calculate the true value of equity, debt is subtracted from the enterprise value and other cash items are re-added. This new equity figure is divided by the company's outstanding shares to represent this value on a per

share basis. This indicates the attractiveness of the share, in terms of whether it is undervalued or overvalued on the valuation date.

Traditionally there are two possible methods when conducting a DCF valuation. These are the unlevered cash flow approach, known as the Free Cash Flow to the Firm (FCFF) method and the levered cash flow approach, known as the Free Cash Flow to Equity (FCFE) method. The main difference between these two methods is that the unlevered FCFF approach accounts for cash flow projections prior to the impact of both debt and cash. Alternatively, the levered FCFE approach accounts for free cash flows after considering both debt and cash. This means that the FCFF approach aims to value a company holistically.

The FCFE approach only values the company's equity portion and does not allow for flexibility when assessing the impact of different capital structures on a company's value. Hence, while this is possible under the unlevered FCFF approach, the capital structure consideration is already incorporated into the levered FCFE valuation.

When performing a DCF valuation, it is important to keep in mind that the model is sensitive to the various input assumptions and resultant forecasts undertaken. The model is heavily-reliant on forward-looking projections that are sound in the context of that company's operations. This can affect the accuracy of the overall estimated intrinsic value derived and makes the DCF model susceptible to error. Should these assumptions and forecasts be largely unjustified and incorrect, this will result in an inaccurate valuation.

6.3.1 The Discount Rate

While the WACC is forward-looking and represents a company's optimal target capital structure, Tencent's actual capital structure is being used as a proxy. This is because it is expected that Tencent will not take on debt in the future and that its equity-only capital structure is its optimal capital structure in the future.

In accordance with Miller and Modigliani's 'Trade-off Theory of Leverage', if a company takes

on debt it will gain an interest tax shield benefit (Modigliani and Miller, 1958: 294). This reduces the cost of debt (K_d) and suggests that a business should choose to take on debt in order to maximize company value. The greater the amount of debt taken on by the company, the larger the tax shield benefit obtained. However, this benefit is limited by the potential for bankruptcy associated with higher debt levels.

Based on the information in Section 6.3.1.4.1, Tencent's average effective tax rate is 10.66%. Taking this into consideration, this rate is low when compared on a relative basis to the Chinese Enterprise Income Tax (EIT) rate of 15% and Hong Kong's corporate tax rate of 17.5%. This translates into a small tax shield benefit for Tencent and creates less of an incentive for the company to take on debt in the future.

Prior to the IPO, Tencent had a large cash pile (see Appendix D, Exhibit 2). As per Tencent's prospectus, the proceeds from the IPO were expected to ensure that the company would have raised sufficient levels of cash in anticipation of future business prospects (Tencent Prospectus, 2004: 31).

Taking the low interest tax shield benefit and large cash piles into account, it is expected that Tencent will not take on debt in the future. This is aligned with other analyst forecasts at this time, which for the same reasons disregard debt as a future item of concern for Tencent in their own valuations.

The WACC is calculated using the following assumptions:

6.3.1.1 Market Value of Equity (MV_E)

Considering Tencent is being valued on its IPO listing date, the company's shares are not publicly traded, hence no market value of equity can be observed on this date. Instead, the market value of equity has been approximated using the confirmed HK$3.70 offer price as a proxy for Tencent's shares.

The total shares outstanding are inclusive of the IPO offer shares. However, the over-allotment option (63,024,000 additional shares) has not been accounted for in this calculation, as the option was not exercised until 05 July 2004 (i.e. after the IPO listing date).

Market capitalization as at 16 June 2004:

Total shares outstanding: 1,680,641,260 Shares[100]
Determined offer price: HK$3.70 per share

1,680,641,260 Shares x HK$3.70 per share

MV_E = HK$ 6,218,372,662

For the purposes of the Discounted Cash Flow (DCF) valuation, the market capitalization has been converted into an appropriate prevailing Chinese Renminbi (RMB) amount to be consistent with the reported figures from Tencent's financial statements. These figures were presented in the Chinese Renminbi (RMB) currency.[101]

This is in accordance with the 1 RMB/ HK$0.94156 HKD exchange rate prevailing on 15 June 2004.

Therefore, (HK$ 6,218,372,662 / 0.94156) = 6,604,329,689 RMB

MV_E = 6,604,329,689 RMB

6.3.1.2 Cost of Equity (K_E)

To calculate the cost of equity, one can consider using the capital asset pricing model (CAPM) or the dividend discount model (DDM).

[100] Regardless of Tencent exercising the clawback mechanism, this did not have an effect on the total number of Tencent shares outstanding as per 16 June, 2004. The clawback mechanism entailed redistribution amongst Hong Kong Offer Shares and International Placement Shares. However, this did not affect the overall total number of shares outstanding on this date.
[101] Note: there is potential for exchange loss or exchange gain upon converting the relevant currencies.

6.3.1.2.1 The Dividend Discount Model (DDM)

$$\mathbf{K_e = (D_1 / P) + g}$$

The DDM method is built around the concept that the current market price of a company's share is directly affected by the future expected dividends of the company. While this method is easy to use, its fundamental problem is that it does not account for risk.

The DDM model can be applied to both private and public companies that pay dividends. This includes private and public companies that may not be paying dividends at the time, but are expected to in the future.

6.3.1.2.2 The Capital Asset Pricing Model (CAPM)

$$\mathbf{K_e = R_f + \beta\ (R_m - R_f)}$$

The CAPM model measures systematic risk in the market and relates expected return to this risk. To compensate investors for taking on the risk, the model incorporates the time value of money (R_f) and risk ($+ \beta\ (R_m - R_f)$) into its formula. Therefore the expected return (K_e) should equal the risk-free return plus a risk premium.

The CAPM model is based on the following assumptions:

1/ All investors have homogenous expectations about asset returns and variances.
2/ Investors can borrow at the risk-free rate.
3/ All assets are marketable and perfectly divisible.
4/ There are no transactions costs incurred and there is no restriction on short sales.

The CAPM model can be applied to both listed and unlisted companies. For an unlisted company it is applied using indirect and approximate methods. It is most suitable for listed companies as it requires several market-related variables such as a measure of company share return volatility relative to the market (β) and market return (R_m). These values are only applicable to listed

entities, and can be derived from the exposure of the entity to its relevant financial market. The DDM model is not a suitable method to use to value Tencent's IPO. As an IPO firm Tencent does not have a public share price (market price), and so the DDM model cannot be applied. Considering the aim of this chapter is to calculate Tencent's market price on its IPO date, this proves that in this context the DDM model is based on circular logic.

Essentially, one of the biggest factors surrounding the IPO is the concept of risk. The CAPM model accounts for this risk, and is thus an effective medium to gauge the company's cost of equity. While Tencent is not a listed firm, the relevant beta value has been derived from the basis of the relative valuation in which a suitable competitor firm, Sohu.com represents Tencent as a proxy. Additionally, while the market return and resultant risk premium are based around estimates, through analytical reasoning and supporting evidence these variables can be derived.

Therefore, in light of the above the CAPM model is the most appropriate option in determining Tencent's cost of equity.

6.3.1.3 CAPM

6.3.1.3.1 Risk-free Rate (R_f)

The 4.82% 10-Year Exchange Fund Note (EFN) 4124 issued on Wednesday 02 June 2004 has been chosen as the appropriate risk-free rate.

Leading up to 16 June 2004, Exchange Fund Notes have been the only Hong Kong Government Bonds available on the market, representing a benchmark risk-free return for other bond issuers and long-term investors (HKCMA, 2004: 15). EFNs were typically denominated in 2, 3,4,5,7 and 10-year maturities. The EFN 4124 was the most current and recent government bond issue relevant to the time period under review, and was trading at 4.56% (HKMA, 2004: 01).

For the purpose of valuing Tencent prior to its IPO, the relevant risk-free rate (R_f) is therefore taken to be 4.56%.

6.3.1.3.2 Beta (**β**)

Considering that Tencent is unlisted, there is no corresponding beta value prior to the IPO. Therefore, based on Section 6.1, a beta for Tencent is approximated by using Sohu.com's beta as a proxy. However, Sohu.com's debt structure comprises of zero coupon convertible senior notes, whereas Tencent does not have and is not expected to have any long-term debt.

Table 6.12: Sohu.com – Unlevered Beta

	Raw Beta	Tax rate	Share Price	Number of Shares	MV of Equity	MV of Debt (BV)	Unlevered Beta
Sohu.com (US$)	1.347	20.15%	22.45	36 378	US$ 816,686	US$ 916,575	**0.710**

β = 0.710

Table 6.12 shows that Sohu.com's raw beta of 1.347 is unlevered to remove the leverage component within the beta value, this ensures that Sohu.com's beta proxy only reflects market risk.

6.3.1.3.3 Market Portfolio Return (R_m)

Table 6.13: Hang Seng Index – Actual Returns from 1988 to 2004

1988	-27.8%	**1994**	15.7%	**2000**	-5.4%
1989	6.7%	**1995**	4.5%	**2001**	-21.5%
1990	14.6%	**1996**	22.1%	**2002**	-14.4%
1991	31.1%	**1997**	-18.0%	**2003**	24.6%
1992	41.4%	**1998**	1.6%	**2004**	16.7%
1993	48.6%	**1999**	51.7%		

Geometric Mean for the 1988 - 2004 Period	8.80%

R_m= 8.80%

The Hang Seng Index (HSI) is the most widely quoted gauge of the Hong Kong stock market (HSI, 2014: 01). HSI data dates back to 24 November 1969, providing a comprehensive, lengthy time period to deduce the relevant market return and market risk premium required as inputs into the CAPM model and the overall DCF valuation process.

The HSI is a free-float adjusted index which largely reflects the investment climate in Hong Kong and the PRC. It accounts for ordinary Hong Kong companies, H Share companies, Red chip companies and other Hong Kong listed Mainland Companies (HSI, 2014: 01).[102] These companies are categorized into one of four main classes: finance, utilities, properties and commerce & industry.

The actual market return achieved on the HSI is calculated using a geometric mean (GM). The geometric mean is used because it is mean reverting and reflects the power of compounding over time. As the performance of the HSI (and other indices) is dependent on its previous performance, the GM provides the most accurate representation of the index's actual historical performance during the 1988 to 2004 period.

6.3.1.3.3.1 Alternative Indices Considered

The most suitable alternative to the HSI is the Hang Seng Composite Index Series (HSCI) which covers a total of 95% of the total market capitalization of those companies listed on the HKEx

Main Board (HSCI, 2014: 1). This market index encompasses all spectrums of market capitalization on the HKEx namely large cap, mid cap and small cap stocks in respective 76.29%, 18.23% and 5.49% proportions.

102

H-Shares – Shares of a company incorporated in mainland China and listed on the Hong Kong Stock Exchange.

B-Shares – Shares in companies based in mainland China trading on either the Shanghai or Shenzhen Stock Exchanges.

Red Chip Stock – Chinese companies incorporated internationally and listed on the Hong Kong Stock Exchange. These companies are controlled to some degree, or completely, by the Chinese government or a recognized Chinese government institution.

P Chip Stock – Chinese companies listed on the Hong Kong Stock Exchange, however they are incorporated in the Cayman Islands, British Virgin Islands (BVI) and Bermuda. These companies operate in mainland China and are run by those in the private sector only.

However, launching on 3 October 2001, the index is relatively new and does not yield a comprehensive time period upon to calculate an effective market return.

The Morgan Stanley China Index was also considered. Also known as the MSCI China Index (MXCN), it comprises of large cap and mid cap stocks with exposure to Chinese H shares, B shares, Red Chip stocks and P Chip stocks such as Tencent (MSCI,2014:1). In total, the MXCN covers approximately 85% of Chinese equities. However, this index proved unsuitable as it does not cover small cap stocks. Hence, it does not provide an accurate spread to represent all firm sizes in the Chinese market.

The MXCN is relatively new and historical data only relates back to the launch date of July 1999.

6.3.1.3.4 Market Risk Premium ($R_m - R_f$)

The market risk premium is calculated as the difference between the Market Return (R_m) and Risk-free Rate (R_f). This equates to 4.24%

= 8.80% - 4.56%
= 4.24%

6.3.1.3.5 Market Value of Debt (MV_D)

Tencent's financial statements indicate that the company does not carry any form of interest-bearing debt whatsoever. For the reasons outlined in Section 6.3.1 this is not expected to change.

The market value of debt is therefore zero.

MV_D = 0 RMB

6.3.1.4 Cost of Debt (K_D)

As the firm does not and is not expected to take on debt, as indicated above in Sections 6.3.1 and 5.3.1.3.5 its cost of debt is zero.

$\mathbf{K_d} = 0\%$

6.3.1.4.1 Tax Rate (T_c)

While it is not strictly necessary to calculate a tax rate given that Tencent has no debt, Tencent's tax situation provides insight into its debt-free capital structure (see Section 6.3.1).

Table 6.14: Tencent Holdings Limited – Average Effective Tax Rate

	Year ended December 31,		
	2001	**2002**	**2003**
Profit before Tax	10,216	143,765	338,209
Taxation (@ 15%)	(1,532)	(21,565)	(50,731)
Effects of Different Tax Rates Applicable to Different Group Entities	(2,665)	(5,990)	(15,111)
Effects of Tax Holiday and other Exemptions Applicable to Group Entities.	-	(12,231)	(56,003)
Reversal of Effects of Tax Holiday and other Exemptions Applicable to Group Entities.	-	12,231	56,003
Total Effect	-	-	-
Income Not Subject to Tax	-	-	(129)
Expenses Not Deductible	-	-	34
Deferred Tax Assets Not Recognised	-	-	36,491
Unrecognised Tax Losses Sustained by the Group.	1,133	150	-
Utilisation of Previously Unrecognised Tax Losses	-	(436)	-
Total Taxation	(399)	(27,841)	(29,446)
Effective Tax Rate	**3.91%**	**19.37%**	**8.71%**
Average Effective Tax Rate	**10.66%**		

$\mathbf{T_c}$ = 10.66%

Table 6.14 represents Tencent's average effective tax rate after removing the effects of tax holidays and other tax exemptions applicable to the group's entities. This is indicative of Tencent's future tax obligations over the forecasted period.

Tencent derives majority of its revenues in the PRC. PRC companies are typically subject to a 30% Enterprise Income Tax (EIT) and an additional 3% local income tax. However, Tencent is incorporated in a defined 'Special Economic Zone' (SEZ) of the PRC and is granted certain tax benefits. Considering the complexities in Tencent's corporate structure (see Section 4.2.2), Tencent Computer, Tencent Technology, Shiji Kaixuan and Shidai Zhaoyang Technology are subject to a reduced EIT rate of 15% (Tencent Prospectus, 2004: 105).

Over the 2001 to 2003 period, the Hong Kong corporate tax rate remained at 16% and this has increased to 17.5% in the 2004 year (KPMG, 2007: 03). Aside from this, Tencent is not subject to income tax or capital gains tax (CGT) in the Cayman Islands and neither are its intermediate holding companies in the BVI. This is attributable to relevant laws of the Cayman Islands and BVI at the time.

Tencent Computer and Tencent Technology received tax holiday benefits over the 2001 to 2003 period. Tencent Computer was exempt from EIT in the 2002 financial year and was subject to a 50% reduction in EIT in the 2003 year. This was according to the provision in the tax circular 'Shendishuierhan [2002] No. 128' (Tencent Prospectus, 2004: 105). Tencent Technology was classified as a 'foreign-invested enterprise with production sales income' and was exempt from EIT in the 2003 financial year as per the tax circular 'Shendishuiwaihan [2003] No. 143' (Tencent Prospectus, 2004: 105).

6.3.1.5 Weighted Average Cost of Capital (WACC)

$[(MV_E / (MV_E + MV_D)) \times K_E] + [(MV_D / (MV_E + MV_D)) \times ((K_D (1 - T_c))]$

Weighting of Equity **(W_E)** = 100%

Weighting of Debt **(W_D)** = 0%

Table 6.15: Tencent Holdings Limited – Weighted Average Cost of Capital (WACC)

Market Value of Equity (HK$)	**HK$ 6,218,372,662**
Outstanding Shares	1 680 641 260
Share Price (HK$)	HK$ 3.7
Market Value of Equity (RMB)	**6,604,329,689 RMB**
Market Value of Debt	**0**
% Equity Weighting	100%
% Debt Weighting	0%
Cost of Debt (Cd):	
Cost of Debt (Pre-Tax)	0.0%
Effective Tax Rate	10.66%
Cost of Debt (After-Tax) (C_d)	**0.0%**
Cost of Equity (C_e):	
CAPM Model	
Risk-free rate (R_f)	4.56%
Beta	0.71
Market Return: Hang Seng Index (R_m)	8.80%
- Risk-free rate (R_f)	4.56%
- Market Risk Premium (R_m - R_f)	4.24%
CAPM Cost of Equity (Ce)	**7.57%**
WACC	**7.57%**

$WACC_{Tencent}$ = 7.57%

Considering Tencent is not expected to carry any form of debt, both its market value of debt and cost of debt are zero. As shown in Table 6.15, this means that Tencent's WACC replicates its current capital structure, being the cost of equity only.

6.3.2 Forward-looking Growth Rate Assumptions for the Following Five-Year Period

Growth rate assumptions play a vital role in deducing an accurate forecast of the target company's future free cash flows. Should one poorly interpret the growth characteristics of the company, this will directly lead to an inaccurate estimate of the target company's intrinsic value.

Growth rate assumptions focus holistically on the economic environment, market environment and internal company environment of the target company. By assessing the current and future potential status of these interrelated factors, the growth levels most likely to be achieved by the target company can be estimated. Both qualitative and quantitative factors need to be taken into consideration, as an all-encompassing approach will ensure good forward-looking projections and an accurate forecast of the company's future free cash flows.

6.3.2.1 Growth Forecasts: The Chinese Economy

6.3.2.1.1 China's Macroeconomic Environment

Historically. China's political and economic transformation has realized a largely growing GDP since 1970 (Otani, 2005: 09). This is illustrated by the economic and industry data in Section 4.4, signaling both the development and growth of the Chinese economy and its increasing technological adoption rate over the 1998 to 2003 financial period.

As per Section 4.4, the Asian Development Bank's forecasted GDP growth estimates substantially outweighed inflationary expectations over the 2004 to 2008 financial period. This mitigates the potential decline in the value of the Renminbi brought upon by China's expected GDP growth. Interpreting the historical and forecasted economic data in Section 4.4, it appears that the Chinese economy will continue to expand over the next five years. As industries grow and productivity increases, income levels in China will rise. This is likely to substantially increase the rate of technological adoption in China's internet, fixed line and mobile industries.

Overall, this should drive significant company growth in the Chinese internet and telecommunication industry.

China's accelerated infrastructural development should continue to enhance internet penetration rates and encourage greater levels of internet diffusion in the near future. With the development and introduction of DSL and ISDN infrastructure in China there is a strong likelihood that internet accessibility and user connectivity costs will decline. This means that as DSL and ISDN internet technologies become the industry standard, older existing technologies should become more affordable. As this comes into fruition this will effectively bridge China's digital divide, closing the gap between those who have internet access and those who previously did not have access or could not afford to do so.

6.3.2.1.2 New Technologies

6.3.2.1.2.1 VoIP

VoIP technology is a form of disruptive technology, creating a new market and value network that has the capabilities of disrupting and replacing existing markets. As a telephony service, VoIP has the potential to erode market share of China's existing mobile and fixed line telecommunication companies: China Mobile, China Unicom, China Netcom and China Telecom. As a pc-based computer-to-computer service, this puts QQ at risk in terms of its longevity and relevance in the internet and mobile value-added service market.

The expected growth in VoIP telephony users in Section 4.5.6.2 shows that VoIP technology is a significant threat to Tencent's future growth potential. This is because Tencent's successful business model is traditionally centered on leveraging off its mobile and PC-based IM offerings and using them to cross-sell its value-added services. While these forecasts were not conclusive, it is more likely than not that Tencent will create and pursue opportunities in an untapped VoIP value-added service segment to accommodate for the rising industry.

This is further substantiated from an excerpt by a publication titled 'VoIP Development in China' stating that, "VoIP telephone services provide an opportunity for internet service providers to earn higher profits… This new opportunity has fostered a new class of ISPs in China: internet telephone service providers" (Hu and Wang, 2004: 30). Tencent's business model and strategic relationship with China's mobile and telecommunication providers would suggest that it is likely it can make an effective transition into the Chinese VoIP industry. Tencent could then develop IM infused VoIP platforms for both mobile and pc users. In alignment with its current business model, Tencent could then use these platforms to leverage-off and cross-sell VoIP value-added services between the two platforms (Smura and Hämmäinen, 2004: 08).

6.3.2.1.2.2 PHS

Taking the information in Section 4.5.6.3 into account, it is clear that Chinese mobile operators are making concerted attempts to effectively launch PHS services to Chinese citizens.
As a low cost alternative to China's mobile phone market, PHS technology presents a valuable opportunity for Tencent to diversify its product and service offerings amidst the competitive environment. By introducing Mobile QQ to the PHS platform, this immediately establishes a relationship between the PHS user and the QQ brand. Once this relationship is established, this can secure brand loyalty and expand Tencent's market reach into other areas of its value-added service offerings.

6.3.2.2 Growth Rate Forecasts: Internal Company Growth

6.3.2.2.1 Mobile Value-Added Services (MVAS)

As per Section 4.5.2, China Mobile and China Unicom have control over the Chinese MVAS industry. Considering that there is no viable alternative, the profitability of Tencent and its competitor's MVAS divisions are directly affected by these mobile operators.

In August 2003 China Mobile enforced both policy changes and regulatory measures to ban companies from offering fee-based services that were not classified as wireless services (CDC Corporation, 2007:35). One month later, China Mobile withheld a total of HK$140,560,000 (US$18,019,820) owed to SINA Corp, Sohu.com and NetEase as well as HK$48,530,000 (US$6,221,556) owed to TOM Online. This delay in payment was because China Mobile said that these companies provided pornographic content to Chinese users. This was believed to be in contravention of China Mobile's company guidelines (Hui, 2003: 01).

This sequence of events highlights the potentially volatile nature of China's MVAS industry in the future. While it is in both parties' interests to cooperate and support each other's operations, there is no guarantee that events such as the above could not occur.

As per Section 4.2.2, all of Tencent's MVAS revenues are derived from Tencent Computer and Shiji Kaixuan. Contractual obligations between these subsidiaries and China Mobile and China Unicom have typically secured Tencent's MVAS revenues and promoted its MVAS offerings across China. As a company, amongst its competitors, relying on these billing and collection services, the volatility involved in this distribution method is potentially unsustainable in the future for the reasons cited above.

Tencent incurs the following MVAS costs from China Mobile and China Unicom:

- A portion of MVAS revenues (fees) are collected from end-users and paid over to China Mobile and China Unicom.

Historically this ranged between 12% and 15% of the overall fees collected over the 2001 to 2003 financial period.

- Imbalance fees are charged by mobile operators when the quantity of messages that are sent/received on Tencent's platforms exceed the number of messages sent/received on the network operator's platform.

Historically Tencent has always paid these balance fees, ranging between 0.04 RMB and 0.08 RMB per SMS and 0.20 RMB – 0.25 RMB per MMS.

These fees can increase at the discretion of mobile operators, and this could adversely affect the financial performance of Tencent's MVAS division in the future. This being said, Infrastructural development is vital to accommodate for the growing mobile user base and resultant increase in demand for MVAS offerings. Essentially, this cost would have to be transferred to Tencent by raising the above mentioned fee structure.

Consideration also needs to be made for the susceptible nature of the MVAS industry to Chinese governmental policy changes. This has the potential to prohibit and restrict growth in China's MVAS industry and is considered when forecasting growth levels of Tencent's MVAS division.

While it is important to consider these factors in forecasting Tencent's growth rates over the five-year period ending in 2008, it must be stated that collectively all companies within Tencent's competitor pool are affected by the status and construct of the MVAS industry.

6.3.2.2.2 Internet Value-Added Services (IVAS)

As per Section 4.4, China boasts the second largest internet population in the world. As a result, this growing industry will affect the forecasted growth of Tencent's IVAS division.

The following factors have been considered when forecasting Tencent's IVAS revenue growth over the 2004 to 2008 financial period:

6.3.2.2.2.1 Foreign Direct Investment (FDI) (see Section 4.2.1, 3.2.2 and Section 4.2.3)

While FDI has worked favorably for Tencent in acquiring investors (see Section 4.2.3 and Section 4.2.4) the Chinese government's liberalization and deregulation movement towards FDI exposes Tencent and its competitors to the threat of new market entrants.

This means that Western multinational corporations (MNCs) are able to bring technologies, skills and knowledge from their local industries to disrupt the Chinese value-added telecommunications service industry. Tencent recognizes Microsoft's MSN Messenger, Yahoo! Messenger and AOL's Instant Messenger (AIM) as potential threats to its position in the instant messaging market. These companies have the potential to influence the future direction of China's internet and telecommunications industry.

Consideration must also be made for strategic-based FDI investment by Western MNCs with one or more of Tencent's competitors. Even though FDI is limited up to a 50% investment threshold (see Section 4.2.2), it has the potential to threaten Tencent's overall market position and company growth. While there is no evidence of this occurring at this time, Tencent's unique industry position and business model could suggest this its competitors may consider this option.

6.3.2.2.2.2 Operating Expenditure and Payment Systems

Due to low credit card penetration rates, Tencent and its competitors collect IVAS revenues via contractual obligations with Chinese telecommunication operators and Chinese mobile operators. These contractual obligations are an effective substitute for online payment systems as they are still in the early stages of development.

These costs incurred by Tencent are structured in the same manner as the MVAS costs incurred in Section 6.3.2.2.1.

In order for Tencent and its competitors to sufficiently provide IVAS services, they need to have the relevant infrastructural and resultant bandwidth capabilities required to do so. In the past Tencent has leased its bandwidth from data centers, however it also owns network servers within these data centers.

The benefit of the IVAS industry is that with its expected growth, Tencent and its competitors may not necessarily have to spend large amounts of CAPEX. The reason here is because these companies can lease further bandwidth as opposed to spending CAPEX on a greater amount of

network servers. Up to this point Tencent has done so by paying a custody fee to ensure that its servers are run off premises and maintained correctly.

6.3.2.2.2.3 Third-Party Content

Tencent's product and service content is outsourced from third party content providers. This is to ensure that its product and service offerings are kept relevant and innovative in the marketplace.

This was particularly made prevalent by the fact that its contractual agreements with third-party content providers are both short-term and non-exclusive. These contracts can also be terminated at any time by either party (Tencent Prospectus, 2004: 26).

While Tencent's core business focus is its IM offerings, there is a strong reliance on content providers and content generated for its complimentary value-added product and service offerings.

The nature of these contracts suggests that Tencent did not have any way of protecting itself or deriving a competitive advantage against its competitors. The non-exclusivity clause infers that the same content provider can be used by a variety of Tencent's competitors. While it would not necessarily be in a competitor's best interests to essentially use the same content provider, it is likely that this may have occurred or may occur in the near future.

This would mean that in terms of the relevant value-added product and service offerings of Tencent and its competitors, the competitive landscape will be defined by first-mover advantage and customer loyalty. Regardless of the relationship of these content providers with competing companies, there is also a limit as to what content is relevant to a specific time period, subject or event. Hence, it is expected that within the next five years the industry will reach this point.

6.3.2.2.3 Online Advertising

While Section 4.5.4 shows that online advertising has represented a small percentage of China's total advertising revenues in the past, this is likely to significantly change in the near future.

As the technological adoption rate in China continues to grow, technology will become more integrated into the lifestyles of Chinese consumers. In this manner, traditional advertisers will have to turn to newly emerging media to stay relevant. This was the case with TOM Online, which restructured its advertising offerings from traditional offline advertising to online advertising in the year 2003.

However, as a relatively new industry the online advertising market is likely to face stringent Chinese regulatory requirements in the near future. This is likely to have a direct effect on the overall levels of growth experienced by China's online advertising industry and the associated growth in online advertising of Tencent and its competitors.

There is also a potential risk surrounding the balance of enabling a user to derive value from an online advert versus spamming the user. Spamming entails using electronic message systems and platforms to send advertising indiscriminately. Should spamming be prevalent, this may have an effect on the user base and growth of online advertising for Tencent and its competitors.

As a response to spamming, users could start to use advertising blockers. Advertising blockers can prevent advertisements from being displayed on a user's device. This may negatively impact online advertising adoption rates and could directly affect the longevity and growth potential of Tencent and its competitor's online advertising segments (Wang, 2003: 01).

6.3.2.2.4 Future Business Acquisitions

As per Section 4.9, Tencent's planned use of IPO proceeds would see future acquisitions of companies involved in the technological development of its real-time communication, entertainment and internet offerings.

These acquisitions have the potential to drive Tencent's growth prospects and achieve larger levels of organic growth over a period of time. Essentially, these acquisitions would lead to technological development in the following fields:

- Video streaming, voice over IP (VoIP), interactive voice response (IVR) technologies and services, wireless presence and voice dialog technologies, push-to-talk mobile data network services, mobile location based technologies and enterprise real-time collaboration technologies and applications. These are all considered core IM and related value-added services.

- Instant messaging (IM)-enabled consumer-to-consumer (C2C) and business-to-consumer (B2C) platforms.

- Casual games, mobile games, MMORPG games, RTS games and other value-added service content. These would be used to enhance Tencent's IM-enabled QQ Game portal.

- Building online social networking communities and online vertical information websites. This includes the potential acquisition of business advertising rank technologies to expand Tencent's online advertising business.

However, there is downside risk involved with acquiring technology companies. If Tencent performs inadequate technical due diligence it may be discovered at a later point that the acquired technology did not perform as expected. There is also potential that the acquired company may not have had clear intellectual entitlement to the technology (Daunt, 2002: 04). Most importantly, the main reason that these potential acquisitions may fail is because Tencent's management may overlook the corporate culture fit between the two companies.

The benefits surrounding these acquisitions are likely to ensure that Tencent can leverage off complimentary technologies and achieve greater levels of company growth in the future. Expanding its product and service offerings will improve the distribution capacity of Tencent. As such, this increases the company's target market and may expand its customer base. Furthermore, by having access to technological infrastructure and the relevant intellectual property rights associated with these acquisitions, this is likely to secure and improve Tencent's market position.

Consideration for these acquisitions has been made when forecasting Tencent's expected company growth over the 2004 to 2008 financial period. It must be stated that no specific company targets were publically provided by Tencent during the period leading up to its IPO.

6.3.3 Growth Forecasts: Income Statement Assumptions

6.3.3.1 Mobile & Telecommunication Value-Added Services (MVAS)

(Forecasted CAGR of revenue generated for the 2003 to 2008 financial period = 49.86%)

(Forecasted CAGR of net profit generated for the 2003 to 2008 financial period = 36.36%)

Table 6.16: Forecasted MVAS Revenues and Cost of Revenues over the 2004 to 2008 Financial Period

Mobile & Telecommunication Value-Added Services (MVAS)								**(RMB'000)**
	2001	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**
Revenues	37960	198 818	467 369	630 948	883 327	1 254 325	2 006 920	3 532 179
Year-on-Year Growth (%)	**-**	**423.8%**	**135.1%**	**35.0%**	**40.0%**	**42.0%**	**60.0%**	**76.0%**
Cost of Revenue	(10 801)	(49 856)	(141 916)	(232 742)	(360 750)	(660 173)	(1 089 286)	(1 982 501)
Year-on-Year Growth (%)	**-**	**361.6%**	**184.7%**	**64.0%**	**55.0%**	**83.0%**	**65.0%**	**82.0%**
As a proportion of Revenues (%)	28.5%	25.1%	30.4%	36.9%	40.8%	52.6%	54.3%	56.1%
Total Profit	27 159	148 962	325 453	398 206	522 577	594 152	917 634	1 549 678
Year-on-Year Profit Growth (%)	**-**	**448.5%**	**118.5%**	**22.4%**	**31.2%**	**13.7%**	**54.4%**	**68.9%**

6.3.3.1.1 Revenues

The MVAS division is forecasted as Tencent's largest revenue contributor over the five-year period.

2004 & 2005 Forecasts

Amidst industry growth, it is likely that Tencent will aim to strengthen its brand and improve its existing MVAS products and services in the 2004 year. As per the user statistics in Section 4.5.2, by the end of the first quarter of Tencent's 2004 financial year its mobile subscribers increased by 103.2% to 12.8 million registered subscribers.

When this three-month growth is compared to the previous year's 12.5% annual subscriber growth as per Section 4.6.1 this is indicative of accelerated technological adoption and mobile penetration rates in China.

Accounting for this, it is expected that this trend will continue in the foreseeable future and that Tencent will achieve positive levels of growth in its MVAS division over the 2004 financial year. It is likely that Tencent will aim to continue building its brand and essentially increase the value of its goodwill further. In doing so, it is expected that Tencent will expand on its MVAS product and service offerings in the 2004 financial year, making use of its large cash pile to supplement its MVAS media and content licensing agreements. This will ensure that the brand maintains its appeal to the Chinese populace as mobile penetration rates continue to rise and technological adoption spreads across the PRC.

Leading into the 2005 financial year, competition amongst Tencent and its competitors is expected to intensify. As the industry continues to grow, it is likely that Tencent will follow the same expected strategies as outlined for the 2004 financial year. As per Section 4.5.2, the large expected segmental growth within industry suggests that it is susceptible to large technological changes in the near future. This being said, Section 4.5.6 shows that it is likely for Tencent to diversify its position in the MVAS industry by introducing value-added services into the VoIP and PHS markets. However, it is expected that Tencent's VoIP and PHS value-added services will still be in the development and beta testing phase in the 2005 financial year.

2006 Forecast

The 2006 financial year is likely to be termed as a transformational year for Tencent's MVAS division. It is expected that Tencent will use a considerable portion of its IPO proceeds to diversify and rollout MVAS offerings for new platforms and technologies. In reference to Section 4.9, Tencent is likely to acquire businesses and form strategic relationships with other businesses during this financial year. These acquisitions could range from any of the MVAS technologies mentioned in Section 6.3.2.2.4.

The premise behind this assumption is that while Tencent has outlined the possible fields of expansion in its IPO prospectus, Section 4.9 states that no specific companies were mentioned by Tencent at the time. By the 2006 year this would have allowed Tencent to pursue R&D efforts to develop in-house technologies and gave the company adequate time to understand the industry in light of technological changes, the sensitivity of adoption rates, the competitive environment, expected growth and the general industry outlook. This means that Tencent can make substantiated business acquisitions with credible synergies to compliment both its existing corporate culture and strategic outlook.

VoIP and PHS R&D efforts are likely to prove fruitful in the 2006 year. This is because it is expected that Tencent will release Mobile QQ and other related value-added services for both platforms in this year. These efforts will ensure that Tencent evolves its business model and stays relevant in the highly-competitive MVAS market environment. However, with the acquisition of new businesses and launch of new offerings there is a likelihood Tencent could incur teething problems. While Tencent would have aimed to test the market by introducing beta versions of its offerings, these services may still need to be debugged and may not operate as intended. This would affect the overall receptiveness of these offerings and distort the true profitability contained within these investments at that point in time.

Taking the holistic overview of these factors into consideration, Tencent's MVAS division is likely to experience a decline in profitability in the 2006 financial year in anticipation of sustained periods of high-growth over the 2007 and 2008 financial years.

2007 & 2008 Forecasts

The 2007 and 2008 financial years are expected to signify a new period of high growth for Tencent and its MVAS division. In light of the transformational efforts to be undertaken in the 2006 financial year, the sacrificed decline in profitability should stand in deep contrast to the company's financial performance over this two-year period and beyond.

The 2007 financial year should realize significant returns for Tencent with regards to its acquired technologies, VoIP and PHS offerings. This is in alignment with the continual increase in mobile penetration and the growing PHS and mobile VoIP markets. By the 2007 financial year, this would have allowed significant time for Tencent to debug and improve these products and service offerings in the continual process of ensuring that they effectively meet user demands. By the 2008 financial year these products and services are expected to be fully received by a majority of new and existing VoIP and PHS users.

Revenue growth surrounding Tencent's general MVAS offerings is likely to substantially grow in the 2007 and 2008 financial years. As Tencent uses its 2006 acquisitions to rollout new products and services, this will substantially increase user activity and MVAS revenues. These offerings will also attract new users which should further enhance MVAS revenues in these years.

This growth is expected to be a result of a push by Tencent to increase QQ's brand exposure combined with accelerated technological development in China. As technologies improve and become more accessible in China this causes a trickle-down effect. As suggested by Section 4.4 this means that the digital divide shrinks and more of the Chinese populace is able to afford and access technology. Therefore, the lower-income populace will be able to use cheaper forms of mobile technologies (i.e. VoIP and PHS) while concurrently developing a relationship with the QQ brand. This relationship can then be carried over to other and improved forms of mobile technology.

Overall, while the growth in 2007 and 2008 revenues are attributable to similar factors, the magnitude of growth achieved in 2008 is fully expected to supersede Tencent's forecasted growth levels in the 2007 year.

6.3.3.1.2 Cost of Revenues

Refer to Table 6.16

As per Section 4.5.2 and Section 4.6 it is clear that historically Tencent's MVAS costs have increased in line with revenue growth. In this manner, Section 6.3.3.1.1 shows that Tencent's overall MVAS subscriber growth is expected to exponentially increase over the 2004 to 2008 financial period.

2004 & 2005 Forecasts

As Tencent's subscriber base grows in the 2004 financial year its mobile partners will collect a larger portion of MVAS revenues. As indicated in Section 6.3.2.2.1 the revenue-sharing fees charged by mobile networks typically range between 12% and 15% of Tencent's revenues. This range is likely to be unchanged in the 2004 financial year. With the 103.2% increase in Tencent's mobile subscribers, this should encourage an increase in imbalance fees paid by Tencent in the 2004 financial year. This is because the quantity of messages that are likely to be sent via Tencent's Mobile QQ platform are expected to exceed those sent via the platforms of network operators.

Using 2003 costing data as per Section 4.6.1, it is expected that Tencent will incur additional MVAS employment costs in the 2004 year. This is to effectively accommodate for the surge in registered subscribers.

The associated structure of Tencent's 2005 MVAS costs are expected to replicate those of the 2004 financial year. The magnitude of these costs will increase in relation to 2005 revenue forecasts, and this is largely driven by continual anticipated growth in Tencent's registered mobile subscribers. This encourages an upwards revision of expected imbalance fees, while staff costs have been revised downwards from previous year estimates.

The expenditure related to content-driven MVAS offerings has been factored into both financial years above and is likely to increase year-on-year over this period.

2006 Forecast

As a transformational year for Tencent, the 2006 financial year should comprise of a different cost structure to the preceding two years of forecasts. As the competitive landscape intensifies, it is expected that Tencent's MVAS division will realize a smaller growth of MVAS subscribers in this year. This is because the increased competition is likely to dilute the market. Accounting for this, it is expected that the fees charged by mobile operators will increase in the 2006 financial year. This would mean that the initial 12% to 15% revenue-share range and imbalance fees are expected to increase (see Section 6.3.2.2.1).

Considering the relative newness of Tencent's assumed business acquisitions in the 2006 financial year, it is highly unlikely that the company will rollout new products and services in the 2006 year alone. Juxtaposed to this, Tencent is expected to realize a large increase in MVAS costs as it introduces its VoIP and PHS offerings into the marketplace for the first time. Herewith, it is expected that PHS network operators (China Netcom and China Unicom) will charge Tencent with PHS-related revenue-sharing and imbalance fee expenditure. Tencent's VoIP offerings are also expected to incur revenue-sharing and imbalance fee expenditure in this regard.

2007 & 2008 Forecasts

Over the 2007 and 2008 financial years, Tencent's MVAS costs are expected to rise considerably. This is in relation to the expected surge in MVAS revenues over this period.

The rollout of new MVAS offerings together with the expected increases in VoIP and PHS adoption rates should encourage a larger MVAS user base and a consequential rise in MVAS costs. Together, it is expected that the trickle-down effect referred to in Section 6.3.3.1.1 will ensure that these costs will raise considerably as revenues consistently grow over the 2007 and 2008 years. This means that Tencent should realize an increase in revenue-sharing and imbalance fees paid to mobile operators in connection with MVAS offerings on traditional mobile, VoIP and PHS platforms. The expansion of Tencent's MVAS platforms has also encouraged a revised

costs estimate surrounding content-related expenses. These expenses have been revised upwards in response to the introduction of PHS and VoIP value-added services amongst traditional mobile platforms.

While holistically Tencent is expected to incur the same costs from the 2006 year in both the 2007 and 2008 financial years, the magnitude of cost growth in the 2008 year is expected to be significantly larger.

6.3.3.2 Internet Value-Added Services (IVAS)

(Forecasted CAGR of revenue generated for the 2003 to 2008 financial period = 60.69%)
(Forecasted CAGR of net profit generated for the 2003 to 2008 financial period = 43.77%)

Table 6.17: Forecasted IVAS Revenues and Cost of Revenues over the 2004 to 2008 Financial Period

Internet Value-Added Services (IVAS)								**(RMB'000)**
	2001	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**
Revenues	944	40 819	229 690	319 269	462 940	712 928	1 261 882	2 460 671
Year-on-Year Growth (%)	**-**	**4224.0%**	**462.7%**	**39.0%**	**45.0%**	**54.0%**	**77.0%**	**95.0%**
Cost of Revenue	(4 223)	(11 848)	(75 489)	(116 253)	(188 330)	(423 742)	(796 636)	(1 513 608)
Year-on-Year Growth (%)	**-**	**180.6%**	**537.1%**	**54.0%**	**62.0%**	**125.0%**	**88.0%**	**90.0%**
As a proportion of Revenues (%)	-447.4%	29.0%	32.9%	36.4%	40.7%	59.4%	63.1%	61.5%
Total Profit	-3 279	28 971	154 201	203 016	274 610	289 185	465 247	947 063
Year-on-Year Profit Growth (%)	**-**	**-983.5%**	**432.3%**	**31.7%**	**35.3%**	**5.3%**	**60.9%**	**103.6%**

6.3.3.2.1 Revenues

As indicated in Section 4.5.1 QQ instant messenger plays an integral role in driving Tencent's revenues in its MVAS and IVAS divisions. Keeping this in mind, it must be stated that Tencent's IVAS offerings include both the PC-based version of QQ instant messenger and additional internet-based product and service offerings.

The IVAS division is forecasted as Tencent's fastest growing segment over the five-year period.

2004 & 2005 Forecasts

As per Section 6.3.2.1, increased Chinese infrastructural development is likely to cause internet diffusion and a reduction in China's digital divide.

Section 4.5.3 shows that within the first quarter of the 2004 financial year the quantity of Tencent's registered IVAS subscribers have increased by 5.8% to 7,3 million. During the same three months, total registered QQ user accounts grew by 13.7% to 291.3 million registered accounts while internet usage time increased by 25.9% to an average of 64.7 million hours. The statistical inferences drawn from this data suggest that this has expanded Tencent's IVAS and IM target markets, and is likely to encourage user-driven revenue growth over the 2004 to 2008 financial years.

Considering the positive growing trend in both internet adoption and the use of Tencent's IVAS and IM services, these statistics further substantiate a consistent expected rise in IVAS subscribers and QQ members over the 2004 and 2005 financial years. Herewith it is expected that users will make use of Tencent's IVAS community and entertainment offerings, increasing overall revenues generated in this period. Additionally, historical revenue trends in Section 4.6 infer that this will also encourage increased adoption rates of Tencent's fee-based Premium QQ and QQ Xing IM services. However, in light of Section 6.3.2.2.2.1 it is likely that that the offerings of Yahoo! MSN and AOL will reduce Tencent's 74.3% dominance of the Chinese IM market. This is expected to reduce the full growth potential of Tencent's IVAS and IM revenues as previously outlined. In contrast, the IM offerings of Tencent's Chinese competitors (see Section 4.5.1) are not expected to have an effect on Tencent's IM market share. This is because they have failed to compete with QQ in the past and this trend should continue amidst Tencent's efforts to recapture lost market share from Western MNCs.

Section 4.1.3 indicates that Tencent had aims at the beginning of the 2004 financial year to become a market leader in China's online gaming space. Therefore, in order to compete directly with NetEase in this area of the IVAS market, it is expected that Tencent will license and introduce additional online game offerings over the 2004 and 2005 financial years.

This will further enhance revenue growth in this segment and increase its competitive position in this market space.

2006 Forecast

As was the case with Tencent's forecasted growth in MVAS revenues (see Section 6.3.3.1.1), the 2006 financial year is expected to transform Tencent's IVAS offerings and encourage large company growth rates in the near future.

With the combined efforts of Western MNCs and Chinese competitor companies, it is expected that Tencent's market share in the IM and total IVAS market space is likely to be under considerable threat in the 2006 year. While the expected number of IVAS and QQ subscribers is likely to rise in the 2006 year, the growth in these subscriber bases is likely to decline when compared to both the 2004 and 2005 financial years. It is expected that Tencent will prevent this by making sufficient use of its IPO proceeds in the 2006 financial year.

In this manner, the diversification of its IVAS offerings expands Tencent's target market and creates opportunity to generate larger quantities of revenues in untapped IVAS market areas. As per Section 6.3.2.2.4 it is expected that Tencent will devote its IPO proceeds and additional cash reserves to acquire existing business in the IVAS and IM market. For the same reasons outlined in Section 6.3.3.1.1, the timing of these acquisitions ensures that Tencent can make substantiated complimentary acquisitions with enough credible synergies to ensure that both parties benefit holistically.

At the same time it is expected that Tencent's IVAS R&D efforts will complimentarily assist these acquired businesses in achieving IVAS revenue growth in the 2006 financial year and beyond. Therefore it is likely that these acquisitions, combined with an accumulation of past and present R&D efforts, should see the rollout of a PC-based VoIP IM offering in the second half of the 2006 year (see Section 6.3.2.1.2.1). Furthermore, this is likely to be accompanied by an updated release of a new PC-based QQ software with integrated C2C and B2C technology during the same period.

Consideration has also been made for the R&D efforts of Tencent's online gaming division as per Section 4.1.3. It is fully expected that Tencent will acquire a gaming development company in 2006 to complement its R&D in this division. However, this has not been factored into 2006 revenue forecasts as it is highly unlikely that Tencent will rollout additional games until the 2007 and 2008 years.

2007 & 2008 Forecasts

The 2007 and 2008 financial years are expected to yield the second largest and largest growth in Tencent's IVAS revenues since 2004.The relevant business acquisitions undertaken by Tencent in the 2006 year are expected to encourage significant growth in IVAS revenues over the 2007 and 2008 financial years. These acquisitions are expected to allow Tencent to continuously innovate and update its IVAS and IM service offerings.

By introducing PC-based VoIP IM services and integrating both C2C and B2C components into its QQ IM software, it is expected that Tencent will attract more IVAS and IM users in these years. This is over and above the general expected growth in IVAS and QQ subscriptions in these years. Accounting for the historical trend in the strategic models of Tencent's competitors, it is expected that these competitors will shift focus away from their attempted IM offerings and continue to compete directly in the IVAS market through their web portals (see Section 4.5.3). This is likely to occur because it is expected that Tencent would have re-established its market position through the acquisition of new businesses and enhancement of its IM and IM-related IVAS offerings.

While Tencent is likely to consistently improve its web portal IVAS services by acquiring additional content, the company is expected to continue following the same strategic model as outlined in Section 4.5.1. Considering Tencent's market position, it is expected that by the 2007 financial year Western MNCs would have disinvested from China's IVAS market collectively. This is likely to be caused by a lack of understanding of Chinese internet culture and the rich historical background of competing Chinese companies.

This suggests that Tencent should regain lost market share in the IM and IVAS market to solidify and enhance this position throughout the 2007 and 2008 financial years.

In terms of the online gaming industry, Tencent is likely to enact upon its 2006 acquisition and release various versions of casual, IM-enabled, RTS and MMORPG games over this two-year period. These game offerings are expected to make an impact on the market environment of China's online gaming industry over the 2007 and 2008 financial years. Therefore, online gaming will play a significant role in contributing to forecasted IVAS revenues over this period.

6.3.3.2.2 Cost of Revenues

Refer to Table 6.17

2004 & 2005 Forecasts

Based on forecasted revenues over this period, the expected increase in IVAS and QQ subscribers is likely to considerably increase Tencent's total IVAS costs over this financial period. To accommodate for these additional subscribers, the increased costs are likely to come from additional bandwidth leasing fees and server custody fees. This would ensure that Tencent is able to meet expected demand for its IVAS services without jeopardizing the quality and reliability of these services. These additional subscribers will also encourage an increase in imbalance fees over the 2004 and 2005 financial years, further inflating Tencent's cost of IVAS revenues over this period (see Section 6.3.2.2.2.2).

It is also expected that cost increases will be realized from the additional licensing of both online games and third party content over this period.

2006 Forecast

The main cost constituents in this year are expected to replicate the same structure as 2004 and 2005 forecasts.

However, the introduction of PC-based VoIP IM and the integration of C2C and B2C components are expected to drive IVAS costs above previous forecasts.

Tencent's PC-based VoIP IM should see the company having to lease a substantially larger amount of additional bandwidth (when compared with previous years), while having to employ additional development and technical staff for this division.
This should be accompanied by an increase in user activity resulting from the integration of C2C and B2C platforms into Tencent's QQ services. This is likely to increase the amount of imbalance fees paid by Tencent in 2006.

2007 & 2008 Forecasts

In light of the forecasted IVAS revenue growth over this period, Tencent's cost structure is expected to replicate the 2006 financial year. Considering the expected changes in industry (see Section 6.3.3.2.1) these costs are likely to increase substantially in the 2007 financial year and again in the 2008 financial year. In addition to this, expectations surrounding Tencent's online gaming division in the 2007 and 2008 years suggest that this will further increase the company's cost of IVAS revenues over this period.

6.3.3.3 Online Advertising

(Forecasted CAGR of revenue generated for the 2003 to 2008 financial period = 54.89%)
(Forecasted CAGR of net profit generated for the 2003 to 2008 financial period = 47.26%)

Table 6.18: Forecasted Online Advertising Revenues and Cost of Revenues over the 2004 to 2008 Financial Period

Online advertising								**(RMB'000)**
	2001	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**
Revenues	7735	19 188	32 841	43 350	59 823	90 931	159 130	292 799
Year-on-Year Growth (%)	**-**	**148.1%**	**71.2%**	**32.0%**	**38.0%**	**52.0%**	**75.0%**	**84.0%**
Cost of Revenue	(3 020)	(6 970)	(10 499)	(12 599)	(16 000)	(31 041)	(67 359)	(138 086)
Year-on-Year Growth (%)	**-**	**130.8%**	**50.6%**	**20.0%**	**27.0%**	**94.0%**	**117.0%**	**105.0%**
As a proportion of Revenues (%)	39.0%	36.3%	32.0%	29.1%	26.7%	34.1%	42.3%	47.2%
Total Profit	4 715	12 218	22 342	30 751	43 823	59 890	91 771	154 713
Year-on-Year Profit Growth (%)	**-**	**159.1%**	**82.9%**	**37.6%**	**42.5%**	**36.7%**	**53.2%**	**68.6%**

6.3.3.3.1 Revenues

The statistical inferences drawn from Section 4.5.4 show that as of the 2003 financial year, Chinese companies began to adopt emerging media and use online advertising as a primary means of promotion.

2004 & 2005 Forecasts

Taking China's infrastructural development and economic growth into account (see Section 4.4); this together with the expected increases in internet usage (see Section 4.5.3) suggests that internet penetration rates will rise in the near future. As this happens, internet is likely to become interwoven into the daily lives of Chinese society. This was already evident in the first quarter of the 2004 financial year as Tencent realized substantial growth in its IVAS and IM subscribers (see Section 4.5.1 and Section 4.5.3).

Accounting for this, it is expected that these factors will attract a larger advertising client base for Tencent, translating into higher revenues generated in its online advertising division over the 2004 and 2005 financial years.

2006 Forecast

As the above-mentioned trend is expected to continue in the 2006 financial year, the adoption of online advertising in China is likely to rise. Based on the context of Tencent's IM-centered business model and the relevant expected growth of its IM users over this period (see Section 6.3.3.2), Tencent's advertising client base should be larger than its competitors.

Section 4.5.4 states that by selling online advertising through their web portals, Tencent's local competitors have collectively followed the same strategic model as each other. When this is contrasted with Tencent's innovative advertising methods as outlined in Section 6.1.1.3, this personal IM-based approach is likely to prove more advantageous for advertising clients. This is because adverts are directly displayed to users and guarantee the relevant exposure required by

Tencent's clients. This is especially relevant in the 2006 financial year as Tencent is expected to enhance and expand its IVAS and IM-based offerings. This is likely to encourage increased web-based and IM user activity which will provide additional brand exposure for clients and create greater value in Tencent's advertising platforms.

It is fully expected that Tencent will acquire and implement advertising rank technologies as per Section 4.9 in the 2006 year. This will enhance its competitive advantage and should potentially increase its advertising client base.

Thus, Tencent's online advertising revenue growth in 2006 should supersede 2004 and 2005 estimates.

2007 & 2008 Forecasts

With the increasing trend in IVAS and IM subscribers and the expected rollout of enhanced and improved web-based offerings, Tencent's online advertising division should reap its highest levels of revenue growth in the 2007 and 2008 financial years. By this time period online advertising is expected to become a conventional norm in China's advertising industry, and the preferred method of advertising undertaken by corporate clients. However, this is also likely to affect industry growth levels and Tencent's advertising revenues in these years.

The influx of online advertising may frustrate Chinese users and detract the value placed on web-based products and services. In response, it is likely that users will begin to implement advertising blockers as mentioned in Section 6.3.2.2.3. Advertising blockers will erode the value in online advertising and are likely to reduce Tencent's advertising client base in this year. Therefore, this has reduced online advertising revenue forecasts over the 2007 and 2008 years. In addition, it is fully expected that the competitive nature and growth of China's online advertising industry will incite regulatory involvement from the Chinese government. While this is speculation, it has been factored into revenue growth forecasts on the basis of being prudent. Therefore, this is likely to shrink Tencent's existing pool of advertising clients and reduces the total expected revenue growth in this division over the 2007 and 2008 financial years.

6.3.3.3.2 Cost of Revenues

Refer to Table 6.18

2004 & 2005 Forecasts

As online advertising revenues are expected to grow over this period, the increased volume of advertising clients will encourage increases in commissions paid to advertising agencies. These commissions are likely to increase in the 2004 year and again in the 2005 year.

2006 Forecast

Accounting for the expected growth in the volume of Tencent's advertising clients, agency commissions will increase in the 2006 year. Over and above this, the implementation of advertising rank technologies will encourage additional employment costs in the online advertising division.

2007 & 2008 Forecasts

The expected rise in online advertising revenues over this period should encourage additional sales commission costs for Tencent. This is despite the relevant concerns surrounding both advertising blockers and potential Chinese regulation of the industry in the future.

6.3.3.4 Other – RTX & Trademark Licensing

(Forecasted CAGR of revenue generated for the 2003 to 2008 financial period = 32.25%)

(Forecasted CAGR of net profit generated for the 2003 to 2008 financial period = 38.73%)

Table 6.19: Other Forecasted Revenues and Cost of Revenues over the 2004 to 2008 Financial Period

Others								(RMB'000)
	2001	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**
Revenues	2437	4 282	5 057	6 119	7 588	10 016	13 821	20 456
Year-on-Year Growth (%)	**-**	**75.7%**	**18.1%**	**21.0%**	**24.0%**	**32.0%**	**38.0%**	**48.0%**
Cost of Revenue	**-**	**-**	(1 644)	(1 841)	(2 025)	(2 370)	(2 607)	(2 920)
Year-on-Year Growth (%)	**-**	**-**	**-**	**12.0%**	**10.0%**	**17.0%**	**10.0%**	**12.0%**
As a proportion of Revenues (%)	**-**	**-**	32.5%	30.1%	26.7%	23.7%	18.9%	14.3%
Total Profit	**-**	**-**	3 413	4 278	5 562	7 646	11 215	17 536
Year-on-Year Profit Growth (%)	**-**	**-**	**-**	**25.3%**	**30.0%**	**37.5%**	**46.7%**	**56.4%**

6.3.3.4.1 Revenues

6.3.3.4.1.1 RTX

Based on the information contain in Section 4.5.5 it is expected that RTX revenues will continue to experience slow and consistent growth in the 2004 and 2005 financial years. In light of the expected development of Tencent's MVAS, IVAS and IM offerings in the 2006 year, Tencent should realize increased RTX revenue growth in the 2006, 2007 and 2008 financial years.

6.3.3.4.1.2 Trademark Licensing

As per Section 4.6.4, it is likely that Tencent will continue to reduce trademark licensing efforts over the 2004 and 2008 years. This is to remain competitive and unique in these future years.

6.3.3.4.2 Cost of Revenues

Refer to Table 6.19

As the adoption rate of RTX systems increase, it is expected that the cost of revenues will rise over the 2004 to 2008 financial period. This is disproportionate to revenue growth.

6.3.3.5 Terminal Growth Rate

In the long-run Tencent will enter into the mature stage of the business cycle and achieve limited growth. As an industry standard, a company's terminal growth rate is typically just above the expected inflation rate over the forecasted time period.

Based on inflation forecasts in Section 4.4 it is expected that China's inflation rate will average at 3.1% over the projected five-year period. Therefore, Tencent's terminal growth rate at time T+5 is expected to be 3.3%.

T+5 = 3.3%

6.3.3.6 Capital Expenditure (CAPEX) Assumptions

Table 6.20: Forecasted CAPEX of Tencent over the 2004 to 2008 Financial Period

Fixed Assets - Property, Plant & Equipment (PPE)			(RMB'000)
	2001	2002	2003
Opening Balance - 01/01/200X	7 821	16 868	38 851
Depreciation	(2 448)	(6 155)	(17 188)
Loss on Disposal of Fixed Asset	-	(18)	(983)
CAPEX	11 495	28 156	59 459
Closing Balance - 31/12/200X	16 868	38 851	80 139

								(RMB'000)
	2001	2002	2003	2004	2005	2006	2007	2008
Capital Expenditure (CAPEX)	11 495	28 156	59 459	71 351	122 723	613 617	276 128	237 608
Year-on-Year Growth %		**145%**	**111%**	**20%**	**72%**	**400%**	**-55%**	**-14%**

Total forecasted CAPEX figures comprise of both Tencent's acquisitions and infrastructural expenditure over the five-year projected period. The reason for including the cost of these acquisitions is because the associated growth has been factored into revenue forecasts in Sections 6.3.3.1, 6.3.3.2, 6.3.3.3, 6.3.3.4. As there is no such thing as a free lunch, this prevents an inconsistent CAPEX projection.

Historically, the IVAS division has been the largest constituent of Tencent's total CAPEX over the 2001 to 2003 period. The CAPEX spend of the MVAS and online advertising divisions have been considerably lower. This difference here is because Tencent has had to ensure that it meets the infrastructural demands of hosting its IVAS services. In contrast, MVAS services are distributed through China's mobile networks and online advertising is outsourced.

This means that as Tencent's overall subscriber base rises, its CAPEX spend will increase. Based on the expected growth of this overall subscriber base in the 2004 to 2008 period, these CAPEX costs will substantially grow.

It is fully expected that Tencent will utilize the entire allocated 65% of IPO proceeds to fund business acquisitions and expansionary projects in the 2006, 2007 and 2008 financial years (see Section 4.9). Majority of this allocated 65% is expected to fund acquisitions in the 2006 year alone. The full 25% of IPO proceeds apportioned for organic growth and business expansion is likely to be expensed (see Section 4.9). This will be in proportionately smaller increments over the 2004 and 2005 years, while majority will be expensed in the 2006, 2007 and 2008 years.

This means that as Tencent's CAPEX spend grows over the five-year forecasted period, it will spend its largest levels of recorded CAPEX in the 2006 financial year alone. This will be accompanied by additional spend in the 2007 and 2008 financial years.

6.3.3.7 Research & Development (R&D)

For the purposes of this DCF model, R&D expenses have been capitalized as CAPEX. Therefore R&D has been accounted for in the forecasted CAPEX amounts over the five-year period.

This is supported by Aswath Damodaran of NYU's Stern School of Business. Damodaran (1996) states that treating R&D as an operating expense immediately reduces and distorts a company's true operating income and net income generated over a review period. This goes against the accounting treatment of R&D as per 'International Accounting Standard 38' (IAS 38) on intangible assets. IAS 38 states that research and development expenditure is recognized as an

expense when incurred and is only capitalized when certain criterion are met (Cazavan-Jeny and Jeanjean, 2003: 02).

However, considering the nature of Tencent's industry, the fast-changing market environment and accelerated pace of technological innovation; R&D expenditure plays a critical role in the intrinsic value placed on Chinese internet and telecommunications companies. Therefore, by capitalizing R&D expenditure to CAPEX this ensures that the DCF model captures an accurate representation of Tencent's intrinsic value on its IPO date.

6.3.3.7.1 Forecasted R&D Expenditure

Table 6.21: Forecasted R&D and Total Adjusted CAPEX Forecasts for Tencent over the 2004 to 2008 Financial Period

								(RMB'000)
	2001	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**
Capital Expenditure (CAPEX)	11 495	28 156	59 459	71 351	122 723	613 617	276 128	237 608
Year-on-Year Growth %		**145%**	**111%**	**20%**	**72%**	**400%**	**-55%**	**-14%**
Research & Development Expenditure (Re-adjusted against IAS 38)	5 610	7 783	26 010	71 528	200 277	276 382	132 663	92 864
Year-on-Year Growth %		**39%**	**234%**	**175%**	**180%**	**38%**	**-52%**	**-30%**
Total Adjusted CAPEX	17 105	35 939	85 469	142 878	323 000	889 999	408 791	330 472

In response to the intended use of IPO proceeds in Section 6.3.2.2.4, Tencent's R&D efforts are likely to increase extensively over the 2004 to 2008 financial period.

The expected rollout of new PHS and VoIP technologies over the 2006, 2007 and 2008 years will encourage Tencent to devote large quantities of R&D expenditure leading up to these earmarked release years. This is amongst other R&D efforts with respect to product and service expansion in Tencent's IM and online gaming (IVAS), MVAS and RTX divisions. Herewith R&D is expected to substantially grow in the 2004 year and at a greater magnitude in the 2005 financial year. This will support and motivate Tencent's acquisitions in the 2006 year and company direction from 2006 moving forward.

In light of the expected rollout and expansionary plans outlined in Sections 6.3.3.1, 6.3.3.2, 6.3.3.3, 6.3.3.4 this R&D expenditure should reach its peak in the 2006 financial year and will lessen in the 2007 and 2008 financial years.

6.3.3.8 Depreciation, Amortization and Impairment (see Appendix D, Exhibit 6)

This is forecasted as a percentage of Tencent's estimated net CAPEX spend over the 2004 to 2008 financial period (see Section 6.3.3.6).

Depreciation is considerably affected by the extent of acquisitions in the 2006, 2007 and 2008 financial years.

It is also likely that Tencent will incur amortization expenditure related to goodwill and other intangible assets incurred from these acquired businesses over this period. Impairment losses related to fixed assets have also been accounted for in these estimates.

6.3.3.9 Selling and Marketing Expenses[103]

Tencent's selling and marketing expenditure has been reported as one total figure in the company's financial statements. There is no further indication as to the apportionment of this expenditure between each of Tencent's operating segments. Therefore, these forecasts have been reported as one total figure.

Based on revenue forecasts in Sections 6.3.3.1, 6.3.3.2, 6.3.3.3, 6.3.3.4 selling and marketing expenses are expected to increase considerably over the 2004 to 2008 financial periods.

While the 2004 and 2005 years are not expected to see new product and service launches from Tencent, the company's selling and marketing costs will increase in each of these years. This is to ensure that Tencent's revenue forecasts are met and that Tencent remains appealing to

[103] These include promotional and marketing activities, third-party advertising, product launch events, printing sales brochures, staff costs, travel costs and entertainment costs. These are just a few of the selling and marketing activities that Tencent had undertaken by 16 June 2004.

new consumers as the Chinese technological adoption rate improves. Throughout this five-year period Tencent will be sought to enhance its market presence in response to expected industry competition and the estimated growth of China's respective MVAS, IVAS, IM, online advertising and online gaming segments. In doing so, Tencent's expected product launches in the 2006, 2007 and 2008 financial years should cause selling and marketing expenses to experience a surge of growth in each of these years. This is aside from increased selling and marketing efforts to promote existing products and services

6.3.3.10 General and Administrative Expenses (see Appendix D, Exhibit 6)

These include salary and welfare expenses, office rental, travel & entertainment expenses, consulting fees, office maintenance, general expenditure related to R&D and other general office expenses.

It is expected that Tencent's general and administrative expenditure will follow the same growth trend as outlined in Sections 6.3.3.1, 6.3.3.2, 6.3.3.3, 6.3.3.4. Particularly, this expenditure should rise considerably from the 2006 financial year moving into the future.

6.3.3.11 Other Operating (Expenses)/Incomes (see Appendix D, Exhibit 6)

It is expected that Tencent's net finance costs will grow in accordance to forecasted company growth as per Sections 6.3.3.1, 6.3.3.2, 6.3.3.3, 6.3.3.4.

6.3.3.11.1 Net Finance Costs

This includes interest expense, interest income, exchange gains/losses and bank charges.

It is expected that the growth in Tencent's net finance costs follow the same trend as forecasted company growth in Sections 6.3.3.1, 6.3.3.2, 6.3.3.3, 6.3.3.4.

6.3.3.12 Working Capital Assumptions (see Appendix D, Exhibit 7 and Exhibit 8)

The constituents of Tencent's working capital are summarized in Table 6.22 below.

Table 6.22: Composition and Predicted Movements of Tencent's Net Working Capital over the 2004 to 2008 Financial Period

Current Assets:	
Accounts Receivable	Included
Amounts due from shareholders	Not Included
Prepayments, deposits and other receivables	Included
Amounts due from shareholders	Not Included
Current Liabilities:	
Other payables and accruals	Included
Amounts due from shareholders	Not Included
Amounts due from shareholders	Not Included
Amounts due from shareholders	Not Included
Income taxes payable	Included
Other taxes payable	Included
Deferred revenue	Included

Collectively, Tencent's current assets are expected to exceed current liabilities over the five-year period. Tencent will experience positive changes in net working capital from 2004 to 2008 except for the 2004 year whereby the net change in working capital will be negative.

For a breakdown of each line item included, refer to Appendix D, Exhibit 8.

6.3.3.13 Items Re-Added to Enterprise Value

These amounts have not been accounted for in the DCF model. Instead they have been re-added to the value of the firm in order to accurately represent the true Enterprise Value (EV) of Tencent after discounting the relevant cash flows at the WACC of 7.57%.

This provides an accurate value of Tencent's share price on its listing date.

6.3.3.13.1 Cash and Cash Equivalents

As this was not captured in the DCF model and was excluded from Tencent's EV calculation, it has been re-added to reflect the total value of the company's equity on its listing date.

6.3.3.13.2 Deposits in Connection with Shiji Kauixuan Technology

As a once-off financing component this is not part of Tencent's daily business operations and was not accounted for in the DCF model. It has been re-added to reflect the total value of the company's equity on its listing date.

6.3.3.13.3 Term Deposits with an Initial Term of over Three Months

As a financing component, this line item represents a component of Tencent's cash and has been re-added to reflect the total value of the company's equity on its listing date.

6.3.3.13.4 Amounts due from Shareholders

These are unsecured, non-interest bearing debt contracts with no fixed payments.

As money that accrues to Tencent, it is not part of Tencent's business operations and was excluded from the DCF model. It has been re-added to reflect the total value of the company's equity on its listing date

6.3.3.14 Estimated Intrinsic Value (see Appendix D, Exhibit 9)

Table 6.23: Discounted Cash Flow (DCF) Calculation – Estimated Intrinsic Value of Tencent on 16 June 2004

	(RMB'000)
Total Firm Value (Enterprise Value)	32 953 261.30
- Long-term Debt	0
+ Cash and Cash Equivalents	325 586
+ Deposit in Connection with the formation of Shiji Kaixuan Technology	11 000
+ Amounts due from Shareholders	82
+ Term Deposits with Initial Term Over 3 Months	23 311
Value of Equity	33 313 240
÷ # Shares	1 680 641
Share Price (RMB)	19.82
Share Price (HK$)	**18.68**
Actual Closing Price - 16 June 2004	
Share Price (RMB)	4.40
Share Price (HK$)	4.15

After applying the relevant forecasted growth rates to the existing framework of Tencent's statement of comprehensive income for the financial years ending 31 December, the respective net operating profit after tax (NOPAT) figures for the 2004 to 2008 period are deduced.

Through the unlevered FCFF approach, the respective NOPAT amounts are adjusted for Tencent's relevant depreciation, CAPEX and changes in net working capital. This determines Tencent's yearly free cash flows for the five-year period.

Each cash flow is then discounted by the WACC of 7.57% (see Section 6.3.1.5). Furthermore, the terminal value (growing at 3.3% over the long-run) is discounted at the same WACC of 7.57%. Altogether this generates Tencent's total Enterprise Value of 32,953,261.30 RMB.

In order to reflect the true value of Tencent's equity, all long-term debt is subtracted from Tencent's enterprise value while all financing/leveraging activities are re-added. As Tencent

does not possess any long-term debt this amount equates to 0 RMB. On the contrary, cash and cash equivalents of 325,586,000 RMB, deposits in connection with the formation of Shiji Kaixuan Technology of 11,000,000 RMB, term deposits with an initial term of over 3 months of 23,311,000 RMB and amounts due from shareholders of 82,000 RMB are re-added to Tencent's enterprise value.

This summates to a total firm value of 33,287,621,000 RMB, which is divisible by the 1,680,641,260 outstanding shares to arrive at an estimated intrinsic value of 19.82 RMB per share. Applying the relevant CNY/HKD[104] exchange rate on 16 June 2004, this equates to a total of HK$18.68 per share.

This share price falls within the HK$14.40 - HK$18.72 share price range as per the relative valuation in Section 6.1. Thus as a reasonability check, it is highly evident that both valuation techniques have provided similar share price outcomes. When compared to Tencent's actual offer price of HK$3.70 this means that Tencent's shares are five times undervalued on 16 June 2004.

[104] 1 RMB = HKD 1.0614 as at 16 June, 2004.

Chapter 7: Underpricing the Offer Shares and Post-IPO Subsequent Events

7.1. Underpricing on the First Day of Listing

Using the case information in Section 4.10 Tencent (HKEx 700) opened on the HKEx at a price of HK$4.375. The share peaked at HK$4.625 on this date before closing at HK$4.150. This translated into a first day's underpricing of 12.2%.[105] This HK$0.45 differential effectively meant that Tencent left money on the table to the value of HK$217,433,025 (US$27,883,536) by pricing its offer shares at HK$3.70, the upper limit of its HK$2.77 – HK$3.70 offer price range.[106]

Applying the respective IPO underpricing theories outlined in Section 3.1, there were various possibilities attributable to the level of underpricing experienced by Tencent on its first day of listing on the HKEx.

7.1.1 IPO Underpricing in the Hong Kong Equity Market

As per Section 4.8, Tencent's IPO launched approximately four years after its NASDAQ-listed competitors. While Qiao (2008) found that IPO underpricing on the HKEx is influenced by previous occurrences of IPO underpricing in industry (see Section 3.1.1), no inferences could be made with regards to Tencent's IPO. This was because four out of Tencent's five direct competitors listed on the US-based NASDAQ exchange. This meant that the overall stimulus behind the levels of underpricing and demand for offer shares would have differed between Tencent's IPO and its competitor's IPOs. Therefore, no direct link could be made between the levels of underpricing in the 2000 year when compared to Tencent's 12.2% first day's underpricing.

[105] [(HK$4.150 – HK$3.7) / HK$3.7] x 100 = 12.2%
[106] 483,184,500 offer shares x [(4.150 – 3.7)] = HK$ 217,433,025

In support of Qiao's (2008) theory surrounding IPO industry clustering, there were two instances of this amongst Tencent and its competitors. The first instance of clustering was the launch of SINA Corp, Sohu.com and NetEase's IPOs in the 2000 financial year (see Table 4.5 in Section 4.7). All three of these competitors launched their IPOs on the NASDAQ within four months of each other.

The second instance of IPO clustering was TOM Online's dual-listing on the NASDAQ and HKGEM in March 2004 and the launch of Tencent's IPO in June 2004. There was a clear relationship between the launch of TOM Online and Tencent's IPOs as both companies listed within four months of each other and on the Hong Kong equity markets.

7.1.2 Asymmetric Information Theory: The Winner's Curse

As per Vong's (n.d.) findings surrounding the SEHK's clawback provision, it was clear that Rock's (1986) 'Winner's Curse' theory as supported by Allen and Faulhaber (1989), Grinblatt and Hwang (1989) and Ljungqvist (2004) was not a credible reason for the occurrence of Tencent's IPO underpricing.

With reference to the structure of the offering as set-out in Exhibit 1 of Appendix B, Tencent's choice to exercise its over-allotment option ensured that a greater amount of Hong Kong Public Offer Shares were made available to uninformed investors. This refuted Rock's (1986) findings that the 'Winner's Curse' is exacerbated by an oversubscription of offer shares prior to the listing date. This was because the 159 times oversubscription in Hong Kong Offer Shares saw the reallocation of 168,064,500 shares from the International Placement to the public investment tranche, ensuring an equivalent amount of 210,080,500 offer shares per each placement type. This created an opportunity for uninformed investors to receive an allocation of the attractively priced IPO offer shares and ensured that markets would operate smoothly.

The terms of application for offer shares in Exhibit 2 of Appendix B further guaranteed a fair and equal opportunity for both informed and uninformed investors to invest in Tencent's IPO. This supplemented the clawback provision. Specifically, this was because Tencent placed a restriction

on multiple share applications from the same applicant, limited to a total maximum application threshold of 50% (21,008,000) of the initial Hong Kong Offer Shares made available. This was further evident through Tencent's sole right to shift share allocation ratios between investors within their respective pools (see 1.1, 1.1.1, 1.1.2 and 1.2 of Exhibit 2 in Appendix B).

This showed that the 'Winner's Curse' theory on the effects of asymmetric information on IPO underpricing was not applicable in the case of Tencent's IPO.

7.1.3 Asymmetric Information Theory: Underpricing as a Signal of Firm Quality

Based on Ibbotson's (1975) findings supported by Allen and Faulhaber (1989), Grinblatt and Hwang (1989), Welch (1996) and Ljungqvist (2004) the reason for underpricing Tencent's IPO was likely to be an intended result of 'leaving a good taste in investors' mouths'.

By leaving money on the table of HK$217,433,025 (US$27,883,536) and consequently underpricing its shares by 12.2%, it was likely that Tencent intentionally suffered losses upfront to signal superior firm prospects in the future. Hence, it had signaled to the market that it was a high quality firm that was prepared to 'suffer' the reduction in capital raised to sustainably benefit over the long-run. This boosted demand for its offer shares and created an opportunity for Tencent to return to the Hong Kong equity market for an SEO at some point in the future.

Supplementing this argument were the additional findings of Grinblatt and Hwang (1989) and Ljungqvist (2004). As per Section 3.1.3 collectively they found that reputable investment bankers, underwriters, auditors and venture capitalists may also enhance the signaling effect of an IPO firm. Applying these findings to Tencent, it was evident that Tencent substantially signaled its firm quality through its IPO roadshow and book building process.

From enlisting both Goldman Sachs (Asia) and the HSBC as its lead underwriters to using reputable audit firm PricewaterhouseCoopers (PwC) as its respected auditors; these factors alone were likely to signal that Tencent was a high quality firm. Furthermore, this was supported by Tencent's ability to maintain a high quality board of directors.

Taking this into consideration, it was more likely than not that Tencent purposefully underpriced its IPO as a signal of firm quality. Considering that the Hong Kong Offer Shares were 159 times oversubscribed and the International Placement Shares were 17 times oversubscribed, it was clear that both informed and uninformed investors were confident in Tencent's quality as a firm and its future growth prospects.

7.1.4 Institutional Theory: Price Support

While Ljungqvist (2004) classified price stabilization or price support as a non-deliberate form of IPO underpricing; there was direct evidence of intent by Tencent to take stabilizing action with regards to its shares.

Following the notion of Ruud (1993) Tencent entered into a 24-day stabilization period with its lead underwriter (Goldman Sachs (Asia)) so that it could prevent stock prices from falling below the original offer price of HK$3.70 per share. Expiring on 10 July 2014, this form of price support would have prevented negative IPO returns. While Chowdhry and Nanda (1996) showed that price stabilization benefits uninformed investors over informed investors and mitigates Rock's (1986) 'Winner's Curse', the SEHK regulatory requirements and compulsory clawback provisions nullify this benefit.

As events played out Goldman Sachs (Asia) did not have to partake in any form of stabilizing action on behalf of Tencent's share price. Hence, tabular data in Exhibit 1 of Appendix E shows that over the 24-day stabilization period Tencent's lowest share price was HK$3.95 per share. This was on Friday 18 June 2004 and repeated again on Monday 21 June 2004. Thus, the stabilization period could be classified as a precautionary measure to mitigate the potential risks of the offer, proving that there was no evidence of share price stabilization by Tencent's lead underwriters.

This suggested that Tencent's level of underpricing could not be attributed to the institutional theory of price support as no stabilizing action was undertaken. It must be noted that the exercising of the over-allotment option on 5 July 2004 was classified as a form of stabilizing

action undertaken by the global coordinator/underwriter (HKEx News, 2004a: 01). However, this was consistent with Tencent's company policy to ensure that the intended ratio of Hong Kong Offer Shares to International Placement Shares was correct (see Appendix B, Exhibit 1 and Exhibit 2). Overall, this action did not materially relate to the share price stabilization theories as outlined by Ruud (1993), Chowdhry and Nanda (1996), Asquith, Jones and Kieschnick (1996) and Ljungqvist (2004) above.

7.1.5 Ownership & Control: Underpricing as a Means to Retain Control

Applying ownership and control theories of underpricing to Tencent's IPO, there was speculatory evidence to suggest that Tencent would have artificially underpriced its offer shares to target specific investors and raise overall company value. This would have increased demand for its offer shares and attracted a diverse range of investors for the company to choose from.

Upon review of Tencent's electronic application results together with the manual white and yellow application forms, this suggested that there was a possibility of bias in Tencent's IPO share allotment (HKEx News, 2004b: 5-18). This was because contrary to the general trend some shareholders had been allotted a larger amount of Hong Kong Offer Shares than others. When taking Point 1.2 of Exhibit 2, Appendix B into consideration Tencent's right to allocate Hong Kong Offer Shares on its own basis further supported this notion. Hence, this related to Brennan and Franks's (1997) 'Reduced Monitoring Hypothesis' in that Tencent may have done so to reduce the amount of scrutiny placed on its management team.

In further support of Brennan and Franks's (1997) findings, linkages could be drawn to Tencent's use of IPO proceeds as outlined in Section 4.9. Taking the above into account, there was a likelihood that Tencent may have enacted upon artificial underpricing to target investors that were complimentary to the firm's future acquisitions. Juxtaposed to this, Stoughton and Zechner (1998) found that an IPO firm's investment bankers will artificially underprice to intentionally favor large institutional investors. This could not have been true in Tencent's case. This was because of the relevant SEHK regulatory requirements and compulsory clawback provision ensuring equitable share allocation between large, informed institutional investors and

small, uninformed private investors. This alone refuted the possibility that Tencent could have used underpricing as a means to reduce agency costs.

Accounting for this information, there was likelihood that Tencent's management may have underpriced its IPO shares as a means to retain control. However, due to the limited public information contained within the IPO application results and the lack of concrete evidence surrounding Tencent's allocation of its public tranche it was indeterminable whether this was a credible reason for Tencent to underprice its IPO offer shares by 12.2%.

7.2 First Day's Underpricing and Post-IPO Subsequent Events (see Appendix E, Exhibit 1)

Figure 7.1:

Tencent's Highest and Lowest Recorded Share Price (HK$) Achieved over the June 2004 to June 2005 Financial Period							
2004				2005			
	Highest	Lowest	Average Volume		Highest	Lowest	Average Volume
June	4.62	3.95	374 102 200	January	4.97	4.28	32 845 100
July	4.45	3.38	55 257 800	February	5.40	4.55	38 859 600
August	4.05	3.38	22 818 900	March	5.95	4.97	24 874 300
September	3.98	3.45	20 569 700	April	5.70	5.00	17 111 300
October	4.80	3.80	46 705 400	May	5.70	5.2	23 830 600
November	6.05	4.43	44 871 500	June	6.65	5.55	29 922 900
December	6.35	4.62	38 187 000				

7.2.1 China Mobile: Sanctions in Mobile Value-Added Services

9 September 2004 marked the first time that Tencent was exposed to sanctions in the MVAS industry. On this date China Mobile temporarily suspended all of Tencent's services on its operating platforms (Tencent, 2004c: 01). Tencent Computer (see Appendix A, Exhibit 6) was in contravention of China Mobile's content requirements pertaining to its mobile IVR services offered. As Tencent only recently entered the IVR market, the respective revenues and overall

repercussion of the suspension did not prove to have a material impact on the company's operations, nor did they represent a material portion of its MVAS revenues over this period.

September 2004 represented the largest decline in Tencent's share price performance over the one-year period ending 30 June 2005. As per Figure 7.1, the share's highest recorded price over the September month alone was HK$3.98 per share.

Regardless of the material effects of the suspension, China Mobile's imposed sanctions had a direct effect on Tencent Computer's rollout of new products & services. This prohibited Tencent Computer from offering new services or launching joint marketing activities on China Mobile's existing platforms for a period of three months. In addition, China Mobile also imposed a six month ban on all Tencent marketing activities on any of its new platforms (Tencent, 2004c: 01).[107]

As Tencent's share price recovered over October 2004 to December 2004, Figure 7.1 shows that the company posted its highest overall monthly share prices of HK$6.05 in November 2004 and HK$6.35 in December 2004. However, as at 16 December 2004 China Mobile also changed its fee-sharing arrangement with Tencent over its 161 Mobile Chat value-added service offering. This fee-sharing arrangement (as per Section 4.6.1) was changed to a pre-determined monthly maintenance fee. This venture represented 10% of Tencent's net profits in the 2003 financial year, and was likely to reduce Tencent's monthly attributable net profits by approximately 4,000,000 RMB or US$48,322 (Tencent, 2004a: 01).[108]

This announcement saw Tencent's share price decline considerably over the remainder of the December 2004 month and through the month of January 2005. Tencent's shares were priced at HK$5.85 on 16 December before closing at HK$5.70 on the same day. By 31 January 2005 the share price declined by 22% to HK$4.55. This was deemed the share's lowest price since reaching HK$4.50 on 11 November 2004 (see Appendix E, Exhibit 1). [109]

[107] This sanction commenced on 15 August, 2004.
[108] [4,000,000 RMB / 8.2770 RMB] = US$48,322
[109] [(HK$4.55 – HK$5.85) / HK$5.85] x 100 = -22.22%

7.2.2 Google Inc and Tencent: Forming a Strategic Alliance

On 2 February 2005 Tencent actively secured an alliance with Western multinational Google Inc. (Google) (Tencent, 2005a: 01). The synergies between the two companies ensured that Tencent could leverage off Google's search capabilities and enhance its online advertising offerings, while Google could penetrate into the Chinese internet and telecommunications market space.

Tencent planned to incorporate Google's WebSearch function into its offerings across its IM services, RTX services and its QQ portal. This effectively ensured that Tencent could maintain its competitive advantage despite increasing market pressure. Furthermore, Google AdSense would also enhance Tencent's online advertising division. This expanded Tencent's appeal to a larger, more diverse target market while concurrently providing sufficient data analytics to enhance its online advertising offerings.

This announcement saw Tencent realize a 114% increase in daily trading volumes from the previous day's total of 24,934,000 shares to 53,495,000 shares. This was the second highest recorded level of trading volumes up to that point in the 2005 year. It did not significantly affect Tencent's share price as it remained within a range of HK$4.70 to HK$5.00 per share (see Appendix E, Exhibit 1).

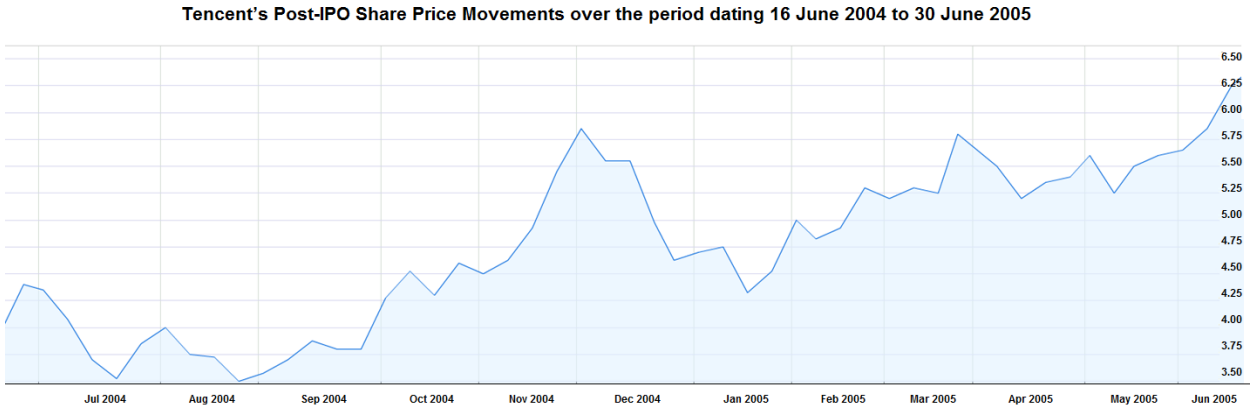
7.2.3 Abnormal Trading Volumes

Tencent experienced abnormally large trading volumes of 208,600,000 shares on 21 2005. This was a 3582.3% increase from 5,665,000 shares traded on the previous day.[110] Upon releasing a statement via the HKEx, Tencent publicly stated that it could not specifically attribute this increase in trading volumes to a specific company event (Tencent, 2005b: 01). This was the second largest recorded volume of trades made since Tencent launched its IPO and led to an 8% increase in Tencent's share price from HK$4.95 to HK$5.35 on this day. [111]

[110][(208,600,000 shares – 5,665,000 shares) / 5,665,000 shares] x 100 = 3582.3%
[111][(HK$5.35 – HK$4.95) / HK$4.95] x 100 = 8.08%

7.2.4 Share Price Performance over the Remaining Four-Month Period

Figure 7.2:



(Google Finance, 2014)

Figure 7.2 shows that Tencent's share price continued to recover and strengthen over the remainder of the period under review. Over the four-month period between March 2005 and June 2005 Tencent's shares achieved consistent, positive growth.

As at June 23, 2005 Tencent shares reached their highest recorded share price since launching the IPO. The share opened on the market at HK$6.40 before peaking at HK$6.65 and closing at HK$6.45 per share. This translated into a 74.3% growth in the share price since listing on the HKEx Main Board on 16 June 2004.

Chapter 8: Conclusion

This case study has focused on three important areas of concern surrounding IPOs. The first being the occurrence of IPO underpricing in the market. IPO underpricing theories suggest that there are numerous reasons why newly listed companies underprice their offer shares. These include deliberate underpricing to encourage uninformed investors to participate in the offering, non-deliberate underpricing as a form of post-IPO share price stabilization and artificial underpricing to avoid or encourage monitoring from public shareholders.

While it was clear that IPO underpricing was a common occurrence on the HKEx, an application of underpricing theories surrounding asymmetric information models, institutional explanations and theories surrounding ownership and control indicated that the 12.2% underpricing in Tencent's IPO shares was attributable to the asymmetric information theory of underpricing as a signal of firm quality. This analysis showed that Tencent left money on the table to encourage positive market sentiment and achieved an oversubscription of demand that was 159 times its public tranche of offer shares available and 17 times its internationally placed tranche of offer shares available. This was accompanied by maintaining a high quality board of directors and enlisting both reputable lead underwriters and auditors to further signal its high-quality nature to the market.

It was also discovered that it was possible that Tencent may have underpriced its shares as a means to retain control of the company. However, due to a lack of credible evidence this was indeterminable and a purely speculative finding.

Most notably, it was found that Rock's (1986) popular 'Winner's Curse' theory of IPO underpricing was null and void in the context of the Hong Kong equity markets. Through a clawback provision, the newly-introduced SEHK share allocation regulations ensured that uninformed investors were afforded the opportunity to purchase shares in HKEx listed IPOs.

This meant that HKEx IPOs would not need to underprice their offer shares to guarantee uninformed investor participation.

The second aspect of IPOs that was investigated was Tencent's decision to list its IPO on the HKEx and go against the industry norm of listing on the NASDAQ. It was discovered that as a BVI incorporated company, Tencent was not permitted to list on the HKEx. This was a result of inadequate BVI shareholder protection rights. As such, Tencent redomiciled to the Cayman Islands to meet HKEx shareholder protection requirements. An analysis of the total fee structure of each exchange indicated that the HKEx Main Board charged total listing fees that were approximately 80.98% to 111.25% cheaper than the NASDAQ National Market at the time of Tencent's IPO.

However, in this analysis it was evident that listing fees were not the predominant factor when choosing an exchange to list on. As a Hong Kong-based company Tencent prepared its financial statements in accordance with HKFRS/IFRS. As US financial reporting standards were prepared according to US GAAP, all companies applying to list on the NASDAQ at the time of Tencent's IPO were to reconcile their financial statements to comply with US GAAP standards. An analysis showed that this would have exacerbated total listing costs incurred by Tencent and an associated time delay was expected to stagnate the IPO process. As a further consideration, it was discovered that for Tencent to comply with the NASDAQ listing requirements it would have had to comply with the US Sarbanes-Oxley Act of 2002 on corporate governance, financial disclosure and public accounting practices. This was expected to additionally increase Tencent's NASDAQ listing costs by HK$226,182,60 in the 2004 year.

The results of this analysis show that US GAAP standards and Sarbanes-Oxley compliance were expected to have a significant impact on the timing of Tencent's IPO launch. These factors would have had a direct effect on analyst's valuations of Tencent, market sentiment surrounding the IPO and the overall demand for its offer shares. Therefore, Tencent would have faced significantly large risk by listing on the NASDAQ National market inferring that it was better suited to list on the HKEx Main Board.

The third aspect of IPOs that was investigated was whether Tencent's IPO offer price was a true reflection of company value on its listing date. In order to value the unlisted company both a relative valuation and DCF valuation were performed.

The relative valuation was performed by comparing the operating segments, place of incorporation, opportunities for international expansion, revenues, gross margins, asset structure and the net profit/(loss) between Tencent, SINA Corp, Sohu.com, NetEase and TOM Online. Based on these factors Sohu.com correlated with 71.4% of Tencent and was used as its proxy firm. Its P/E ratio and P/S ratio were adjusted upwards by 2 and 1.25 respectively to represent Tencent's risk and growth profile, and a price range of HK$14.40 - HK$18.72 was achieved.

Using the unlevered FCFF approach, the WACC was calculated at 7.57%. It was deduced that Tencent's optimal capital structure would continue to be 100% equity-weighted in the future. This was because it was discovered that Tencent's average effective tax rate provided a low tax shield benefit at 10.66%, while Tencent's large cash piles were adequate to meet future growth prospects. The CAPM model was used to calculate Tencent's cost of equity, whereby Sohu.com's beta was unlevered to represent a proxy beta for Tencent. After applying the relevant forecasted growth rates, it was clear that Tencent's MVAS division would generate the most revenue over the 2004 to 2008 financial while its IVAS division would be the fastest growing operating segment. In the long-run it was expected that Tencent would grow at a 0.2% premium above the average forecasted Chinese inflation rate over the five-year period under review. This terminal growth rate was 3.3%.

After discounting the relevant cash flows by the WACC and re-adding all cash items to Tencent's enterprise value, the estimated intrinsic value per share was HK$18.68. Combining this with the outcome of the relative valuation model and it was observable that the HK$18.68 falls between the HK$14.40 - HK$18.72 price ranges. The implications of both valuation models show that Tencent's shares were five times undervalued, which proves that Tencent's IPO offer price was far below its true intrinsic value on this listing date.

Altogether, this shows that Tencent represents a unique IPO case. Tencent defied historical IPO trends in the Chinese value-added service industry, setting precedent as the first of its kind to list on the HKEx. Amidst negative global market sentiment Tencent underpriced its offer shares to effectively signal its high-quality nature to the market, pricing these shares five times below its intrinsic value. Tencent superseded analyst expectations by creating and achieving market demand exceeding 159 times and 17 times its public tranche and placing tranche of offer shares available. While some may say that Tencent's IPO was a success, others could argue the contrary. This is because the original shareholders lost an enormous amount of wealth to new shareholders. Regardless, it is clear that Tencent's IPO paved its road to success as China's largest internet firm and Asia's most valuable brand of today. [112]

[112] Perez, B. 2014. *Tencent Overtakes China Mobile to Become Asia's Most Valuable Brand.* Available: http://www.scmp.com/business/china-business/article/1517430/tencent-overtakes-china-mobile-become-asias-most-valuable [2014, August 24].

Appendix A: The Case Background – Tencent and the Chinese Internet and Telecommunications Industry

Exhibit 1: HKD / RMB and USD / RMB Exchange Rates over the 2001 to 2004 Period [113]

Hong Kong Dollar (HK$)/Chinese Renminbi (RMB) conversion rates:

2001: HK$1 = 1.061 RMB
2002: HK$1 = 1.061 RMB
2003: HK$1 = 1.061 RMB
2004: HK$1 = 1.062 RMB

United States Dollar (US$)/Chinese Renminbi (RMB) conversion rates:

2001: US$1 = 8.2771 RMB
2002: US$1 = 8.2770 RMB
2003: US$1 = 8.2770 RMB
2004: US$1 = 8.2777 RMB

The United States Dollar (US$)/Hong Kong Dollar (HK$) on 16 June 2004: US$1 = HK$7.7979

[113] Tencent Holdings Limited. IPO Prospectus- Hong Kong Public Offering and International Placing. Available: http://globaldocuments.morningstar.com/documentlibrary/document/137bb96118b048a4.msdoc/original [2014, February 27].
Chinability. Renminbi exchange rates 1969 - 2011. Available: http://www.chinability.com/Rmb.htm [2014, March 28].
The World Bank. 2014. Official exchange rate (LCU per US$, period average).Available: http://data.worldbank.org/indicator/PA.NUS.FCRF?page=2 [2014, March 05].
Free Currency Rates. 2014b. *USD/HKD (United States dollar/Hong Kong dollar) Year 2004 Exchange Rate History.* Available: http://www.freecurrencyrates.com/exchange-rate-history/USD-HKD/2004 [2014, April 09].

Exhibit 2: Chinese Economic and Technological Penetration Data for the 1998 to 2003 Period [114]

Chinese Economic and Techonlogical Penetration Statistics							
	1998	1999	2000	2001	2002	2003	CAGR (1998 - 2003)
China's population (in millions)	1,248	1,258	1,267	1,276	1,285	1,292	0.7%
China's GDP per capita (RMB)	6,038	6,551	7,086	7,651	8,184	9,030	8.4%
Per capital annual disposable income of city households (RMB)	5,425	5,854	6,280	6,860	7,703	8,472	9.3%
Internet users (in millions)	2.1	8.9	22.5	33.7	59.1	79.5	106.8%
Internet penetration	0.2%	0.7%	1.8%	2.6%	4.6%	6.2%	-
Mobile subscribers (in millions)	25	43.2	85.3	144.8	206.6	268.7	60.8%
Mobile penetration	2.0%	3.4%	6.7%	11.3%	16.1%	20.8%	-
Fixed Line – access lines in service (in millions)	87.4	108.8	144.4	179	214.4	263.3	24.7%
Fixed Line penetration	7.0%	8.6%	11.4%	14.0%	16.7%	20.4%	-

Historical Chinese Inflation Rate between 1999 to 2003	
1999	1.13%
2000	-0.73%
2001	0.73%
2002	0.35%
2003	-1.40%

[114] Tencent Holdings Limited. IPO Prospectus- Hong Kong Public Offering and International Placing. Available: http://globaldocuments.morningstar.com/documentlibrary/document/137bb96118b048a4.msdoc/original [2014, February 27]. Asian Development Bank. 2014. *Asian Development Outlook.* Available: http://www.adb.org/publications/series/asian-development-outlook?page=1 [2014, July 19].

Exhibit 3: Tencent User Statistics [115]

Historical Tencent User Statistics (Millions)	2001	2002	2003	Q1 2004
Registered IM User Accounts (At End of the Period)	93.2	151.3	256.1	291.3
Active User Accounts	43.8	54.4	81.5	97.1
Peak Simultaneous Online User Accounts	1.9	2.9	4.8	6.1
Average Daily User Hours	18.3	28.6	51.4	64.7
Average Daily Messages (Between PCs Only)	413.9	386.4	681.8	848.8
Fee-based IVAS Registered Subscriptions	-	1.5	6.9	7.3
Fee-based MVAS Registered Subscriptions	1.4	5.6	6.3	12.8

QQ User Statistics (Millions)	2001	2002	2003	Q1 2004
Average Daily User Hours	18.3	28.6	51.4	64.7
Average Daily Messages	413.9	386.4	681.6	848.8

Month	Simultaneous Online Users (Millions)	Duration (Months)
May 2000	0.1	-
February 2001	1	9
March 2002	2	13
February 2003	3	11
September 2003	4	7
February 2004	5	5
March 2004	6	1

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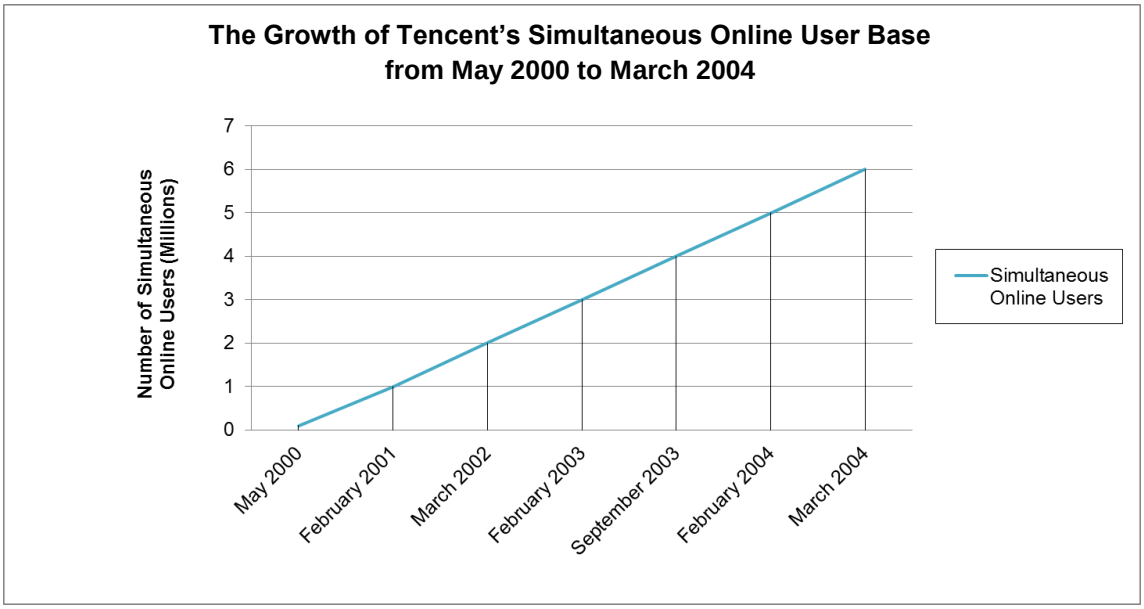
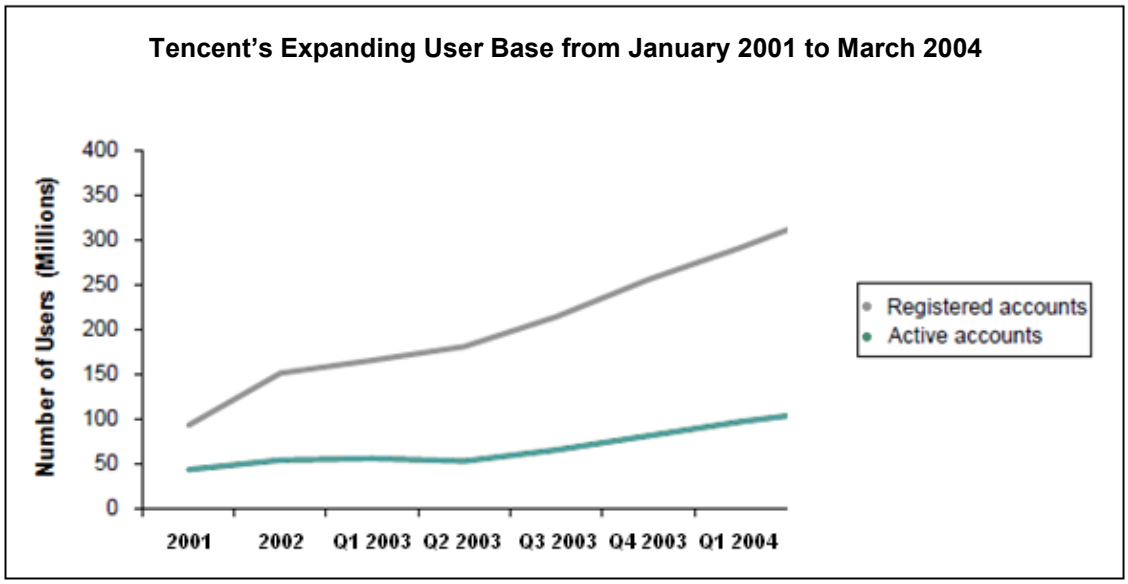
Tencent Holdings Limited. IPO Prospectus- Hong Kong Public Offering and International Placing. Available: http://globaldocuments.morningstar.com/documentlibrary/document/137bb96118b048a4.msdoc/original [2014, February 27].
ChinaKnowledge Press. 2004. *China Business Guide: 2004 Edition*. Available: http://books.google.co.za/books?id=yQGlmWPQFR0C&pg=PT120&lpg=PT120&dq=Chinese+internet+users+below+30+in+2004&source=bl&ots=CPSkUfUzn3&sig=hCkiu207fOGV1MjAToL1fg8GLZk&hl=en&sa=X&ei=RHtOU4rTEcKm0QXujIF4&ved=0CDsQ6AEwAQ#v=onepage&q=Chinese%20internet%20users%20below%2030%20in%202004&f=false [2014, May 11].





27 May 2000 marked Tencent QQ online user accounts peaking at 100,000 for the first time in the company's history. Tencent was the first network in China to achieve this, serving as a landmark event for the company. [116]

[116] Tencent. 2014a. *Simultaneous Online User Accounts of Tencent QQ peaked at 100,000 for the First Time.* Available: http://www.tencent.com/en-us/at/pr/detail.shtml?id=at_2001_20000528 [2014, March 14].

Exhibit 4: Chinese Online Gaming, Online Advertising and Internet Activity Statistics [117]

Average Chinese Internet User Usage Time and Frequency per Week						
	2001 June	2001 December	2002 June	2002 December	2003 June	2003 December
Time (Hours)	8.7	8.5	8.3	9.8	13.0	13.4
Frequency (Times)	3.3	3.2	3.1	3.4	4.1	4.0

Forecasted Growth of China's Online Game Subscription Revenues over the 2003 to 2008 Financial Period (US$'000)						
	2003 (Actual)	2004	2005	2006	2007	2008
Revenues (US$)	159.7	237.7	336.1	462.1	622.0	822.9
Year-on-Year Growth (%)	-	48.9%	41.4%	37.5%	34.6%	32.3%
CAGR (2003 to 2008)						**38.8%**

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Tencent Holdings Limited. IPO Prospectus- Hong Kong Public Offering and International Placing. Available: http://globaldocuments.morningstar.com/documentlibrary/document/137bb96118b048a4.msdoc/original [2014, February 27].
ChinaKnowledge Press. 2004. *China Business Guide: 2004 Edition*. Available: http://books.google.co.za/books?id=yQGlmWPQFR0C&pg=PT120&lpg=PT120&dq=Chinese+internet+users+below+30+in+2004&source=bl&ots=CPSkUfUzn3&sig=hCkiu207fOGV1MjAToL1fg8GLZk&hl=en&sa=X&ei=RHtOU4rTEcKm0QXujIF4&ved=0CDsQ6AEwAQ#v=onepage&q=Chinese%20internet%20users%20below%2030%20in%202004&f=false [2014, May 11].

Forecasted Growth of China's Online Advertising Revenues over the 2003 to 2008 Financial Period						
						(US$'000)
	2003 (Actual)	**2004**	**2005**	**2006**	**2007**	**2008**
Revenues (US$)	63.0	96.0	129.5	173.8	240.5	344.0
Year-on-Year Growth (%)	-	52.4%	34.9%	34.2%	38.4%	43.0%
CAGR (2003 to 2008)						**40.4%**

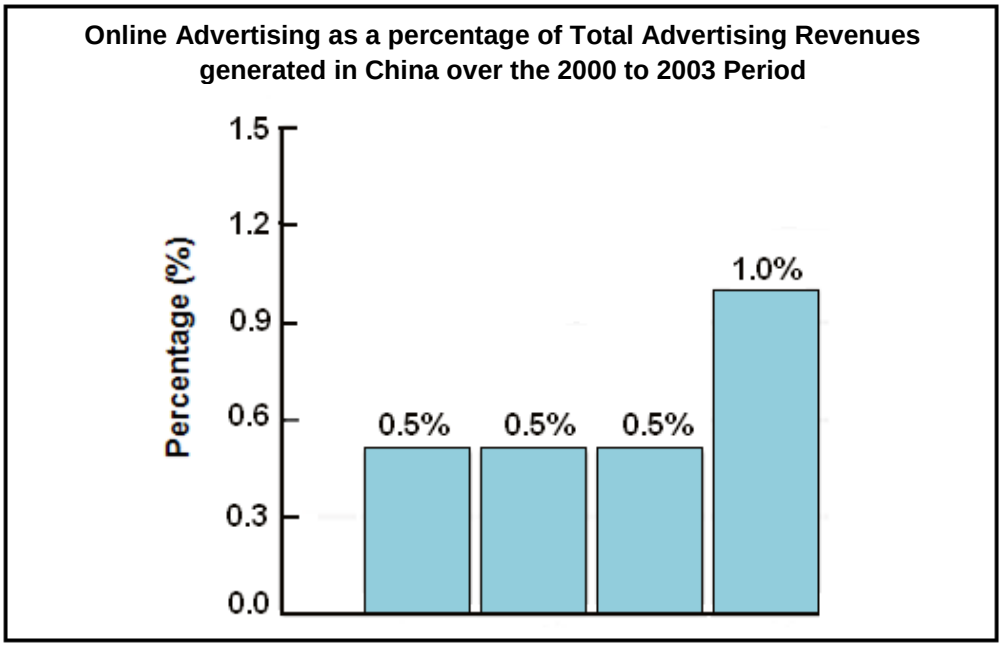
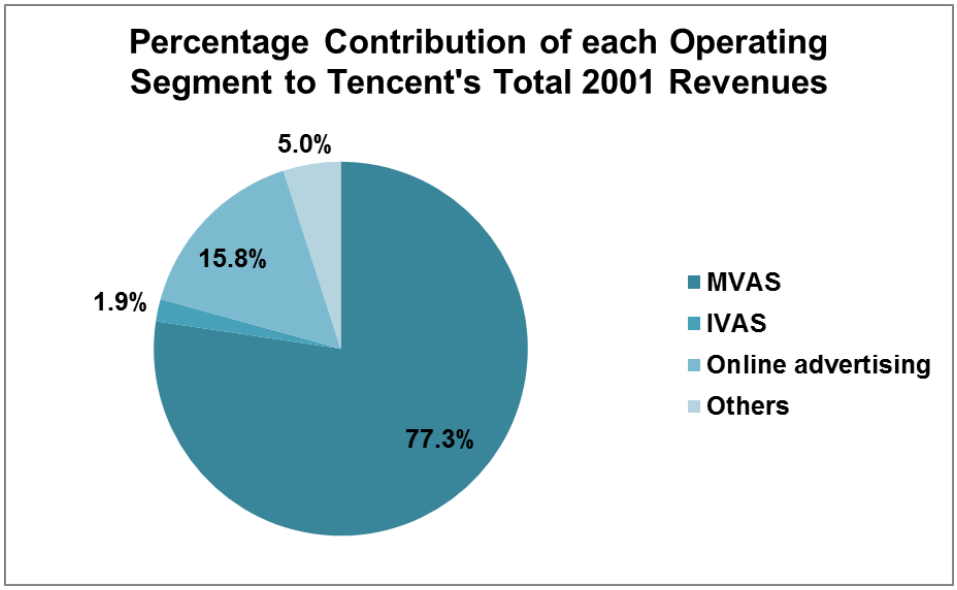
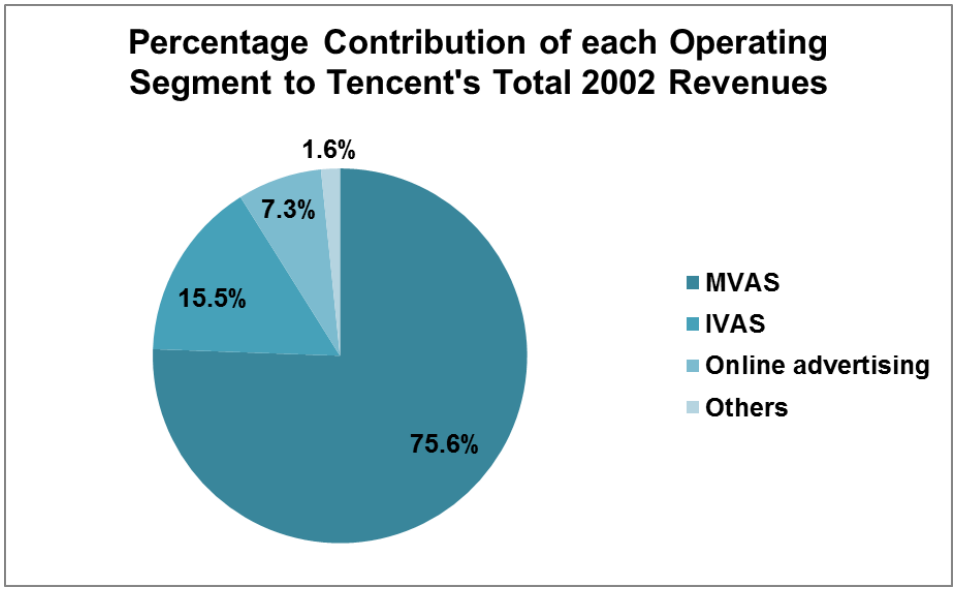
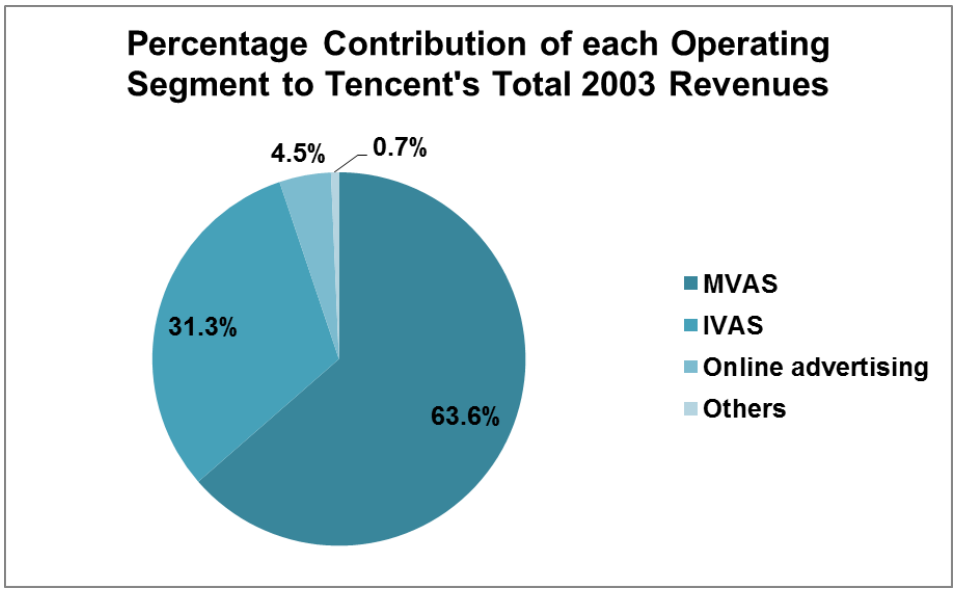


Exhibit 5: Historical Operating Segment Performance Review for Tencent over the 2001 to 2003 Financial Period [118]





[118] Tencent Holdings Limited. IPO Prospectus- Hong Kong Public Offering and International Placing.Available: http://globaldocuments.morningstar.com/documentlibrary/document/137bb96118b048a4.msdoc/original [2014, February 27].


Percentage Contribution of each Operating Segment to Tencent's Total 2003 Revenues
4.5%
0.7%
31.3%
63.6%
MVAS
IVAS
Online advertising
Others

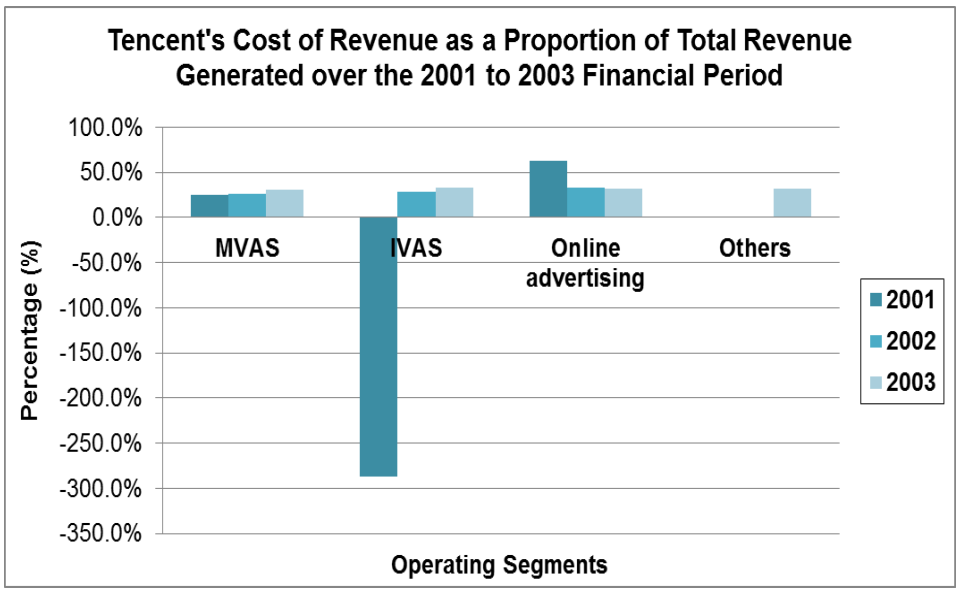
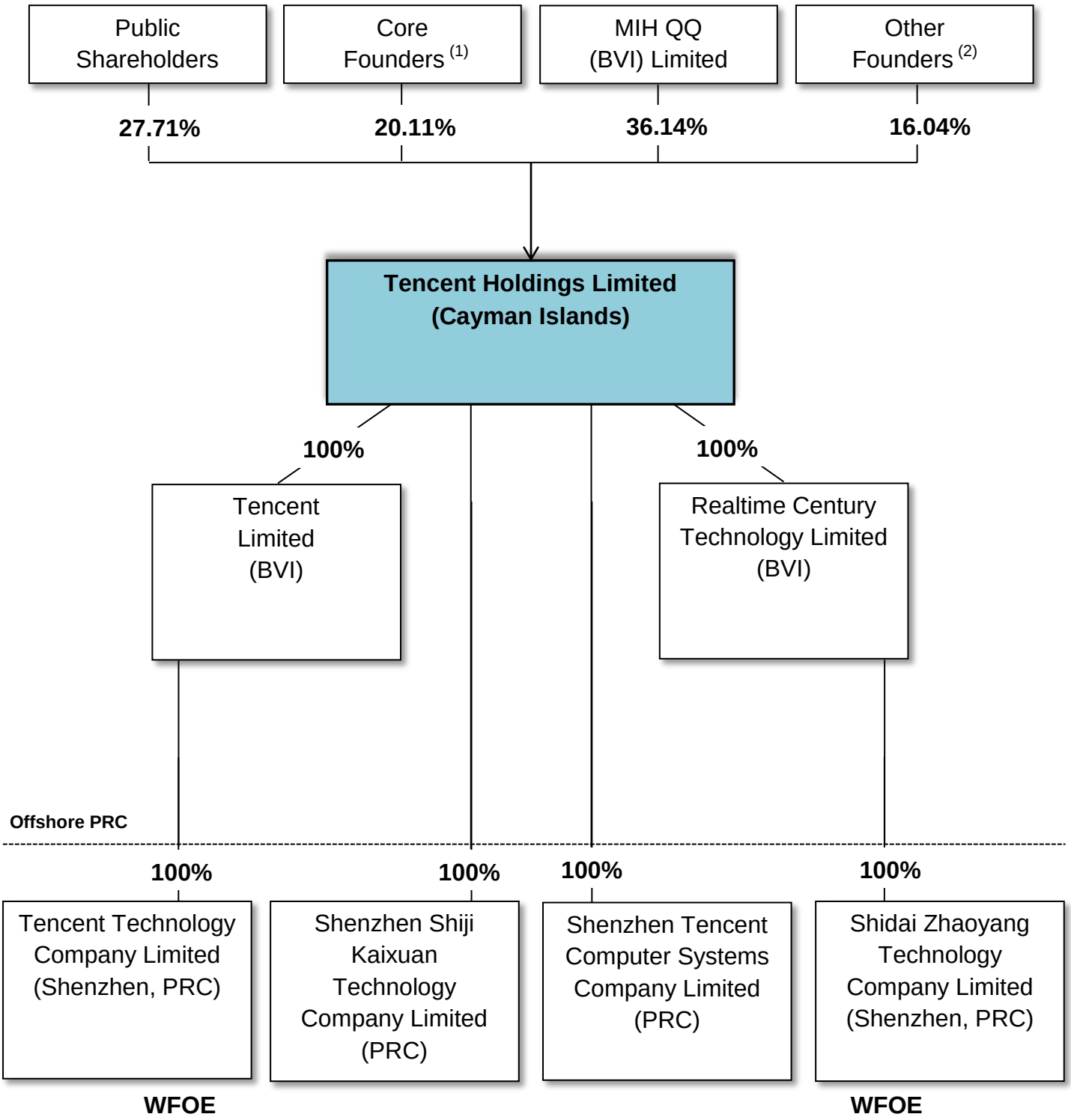

Tencent's Cost of Revenue as a Proportion of Total Revenue Generated over the 2001 to 2003 Financial Period
100.0%
50.0%
0.0%
-50.0%
-100.0%
-150.0%
-200.0%
-250.0%
-300.0%
-350.0%
Percentage (%)
MVAS
IVAS
Online advertising
Others
Operating Segments
2001
2002
2003

Exhibit 6: Tencent Post-IPO Group Structure [119]



[119] Tencent Holdings Limited. IPO Prospectus- Hong Kong Public Offering and International Placing.Available: http://globaldocuments.morningstar.com/documentlibrary/document/137bb96118b048a4.msdoc/original [2014, February 27].

[1] 'Core Founders' refer to Ma Huateng's ownership stake, through his BVI-incorporated wholly owned holding company,Advance Data Services Limited and Zhang Zhidong's ownership stake through BVI-incorporated wholly owned holding company, Best Update International Limited.

Exhibit 7: Terms of Agreement between Tencent and MIH [121]

- Voting between both MIH and Tencent's founders will ensure that both parties vote an equal number of Directors. Voting in this regard relates to both the board of Tencent, and the board of directors of Tencent's Equity Controlled Subsidiaries.[122]

- It is agreed upon that MIH will nominate Tencent's Chief Financial Officer (CFO), while the Founders will nominate Tencent's Chief Executive Officer (CEO).

- It is agreed by both parties that the Articles will be amended to ensure that a 75% majority of shareholders or directors must be present and voting at the relevant general meeting or board meeting in relation to shareholders' resolutions, directors' resolutions and Equity Controlled Subsidiaries. The amendment will remain in effect for three years after the 24 March 2004 adoption date. The amendment will cease with effect from 24 March 2007.

- The Shareholders Agreement will expire the third anniversary of the adoption date - 24 March 2007. Should MIH cease to hold a minimum of 15% of Tencent's share capital, the founders can terminate the agreement prior to the above-mentioned date. Should the founders cease to hold, in aggregate, a minimum of 15% of the company's share capital, MIH may terminate the agreement prior to 24 March 2007.

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[2] 'Other Founders' refer to Tencent's remaining founders whose ownership is held through their own BVI-incorporated holding companies.

[121] Tencent Holdings Limited. IPO Prospectus- Hong Kong Public Offering and International Placing.Available: http://globaldocuments.morningstar.com/documentlibrary/document/137bb96118b048a4.msdoc/original [2014, February 27].

[122] 'Equity Controlled Subsidiaries' refer to those wholly owned subsidiaries which Tencent accounts for through the equity method. This means that on initial investment, Tencent would record this investment at cost and periodically adjust this to reflect the changes in value as a result of the invested company's incomes or losses.

Exhibit 8: IPO Listing Requirements of the Hong Kong Stock Exchange – Financial Tests[123]

HKEx Main Board listing applicants must meet one of three financial tests:

1. **The Profit Test**

→ The listing applicant, or its group, must have management continuity for at least three years preceding the year in which listing will occur.

→ The listing applicant, or its group, must have ownership continuity and control for at least the most recent audited financial year.

→ The listing applicant, or its group, must have profits generated by activities in the ordinary and usual course of the business of at least HK$20 million for most recent financial year.

→ The listing applicant, or its group, must also have aggregate profits of at least HK$30 for the two preceding financial years.

→ Applicants listing under the profit test must also have an expected market capitalization, at the time of listing, of no less than HK$200 million.

2. **The Market Capitalization/Revenue Test**

→ The listing applicant, or its group, must have a trading record of not less than three financial years.

→ The listing applicant, or its group, must have management continuity for at least three years preceding the year in which listing will occur.

→ The listing applicant, or its group, must have ownership continuity and control for at least the most recent audited financial year.

→ The listing applicant, or its group, must have an expected market capitalization of at least HK$4 billion at time of listing.

→ The listing applicant, or its group, must yield revenue of at least HK$500 million arising from principal activity of the applicant in the most recent audited financial year.

→ There must be a minimum of 1,000 shareholders at the time of listing.

[123] HKEX.2004a. *Chapter 8- Equity Securities: Qualifications for Listing.*Available: https://www.hkex.com.hk/eng/rulesreg/listrules/mbrulesup/documents/ch%208.pdf [2014, February 28]
Charltons Law.2013. *The Hong Kong Stock Exchange- IPO Overview*.Available: http://www.legalink.ch/Root/Sites/legalink/Resources/Questionnaires/IPOs/Asia/Legalink%20IPO_HongKong.pdf [2014, February 28].

3. **The Market Capitalization/Revenue/Cash Flow Test**

→ The listing applicant, or its group, must have a trading record of not less than three financial years.

→ The listing applicant, or its group, must have management continuity for at least three years preceding the year in which listing will occur.

→ The listing applicant, or its group, must have ownership continuity and control for at least the most recent audited financial year.

→ The listing applicant, or its group, must have a market capitalization of at least HK$2 billion at time of listing.

→ The listing applicant, or its group, must yield revenue of at least HK$500 million for most recent audited financial year.

→ The listing applicant, or its group, must yield positive cash flow from the operating activities of the listing applicant, or its group, of at least HK$100 million in aggregate for the three preceding financial years.

Appendix B: The Case Background – Tencent's IPO Offer

Exhibit 1: Structure of the Offering [124]

Over-Allocation Option

Should the number of offer shares applied for in the Hong Kong Public Offering represent (i/ , ii/ , iii/) of the number of offer shares initially available under the Hong Kong Public Offering:

i/ 15 times or more, but less than 50 times.
ii/ 50 times or more, but less than 100 times.
iii/ 100 times or more.

Then the total number of offer shares available under the International Placement will be reduced according to the relative associated increase of Hong Kong Public Offering shares additionally made available:

i/ 126,048,000 (~30% of the total number of offer shares initially available)
ii/ 168,064,000 (~40% of the total number of offer shares initially available)
iii/ 210,080,000 (~50% of the total number of offer shares initially available)

Reduction of Offer Shares

1. The global coordinator, Goldman Sachs (Asia), has complete discretion to reduce the amount of offer shares or offer price range as per the company prospectus.

[124] Tencent Holdings Limited. IPO Prospectus- Hong Kong Public Offering and International Placing.Available: http://globaldocuments.morningstar.com/documentlibrary/document/137bb96118b048a4.msdoc/original [2014, February 27].

1.1. The decision to do so is based on the level of interest expressed by prospective professional and international investors at the time, during the book-building process.
1.2. Discretion is granted up until the morning of the last day for lodging applications in specifically the Hong Kong Public Offering.
1.3. Any event of this nature will be published in both the South China Morning Post (English) and the Hong Kong Economic Times (Chinese) in relation to the allocated time period as per 1.2.

2. Once an application for Hong Kong Offer Shares has been submitted, it cannot be withdrawn whatsoever.

3. Should the amount of offer shares be reduced, the global coordinator has full discretion to reallocate the proportional construct of offer shares available for the Hong Kong Public Offer and the International Placement.
3.1. This is subject to the condition that the number of Hong Kong Offer Shares shall not be less than 10% of the total number of offer shares available.

Exhibit 2: Terms of Application for Offer Shares [125]

Hong Kong Public Offering

1. Share applicants (or those acting on their behalf) for the Hong Kong Public Offering are restricted from applying for shares in the International Placement. It must be confirmed in the application form submitted that there is no indicated interest in this manner. Should such agreement be breached or untrue, such applicant's application will be rejected.

1.1. Share applicants may only apply to either Pool A or Pool B shares. Multiple applications from the same applicant (or those acting on their behalf) will be rejected.
1.1.1, Multiple applications, or suspected multiple applications, for an amount of shares that exceeds the total number of 21,008,000 Hong Kong Offer Shares allocated per Pool A and Pool B will be rejected.
1.1.2. No single applicant may apply for more than 21,008,000 Hong Kong Offer Shares. This equates to 50% of the initial Hong Kong Offer Shares made available.

1.2. Share applicants in either Pool A or Pool B may receive different share allocation ratios.
1.2.1. Should the offer shares in either Pool A or Pool B be under-subscribed, the excess of the greater pool will be distributed to the under-subscribed pool in order to satisfy demand accordingly.

1.3. Upon applications, all applicants are required to pay a maximum offer price of HK$3.70 per Hong Kong Offer Share.
1.3.1. Should the offer price be less than the HK$3.70 threshold, the company will refund applicants of the difference between the two amounts i.e. HK$3.70 – final offer price.
1.3.2 In reference to 1.3.1 a refund will only occur if the offer price is less than HK$3.70 after accounting for transaction costs.
1.3.3. In reference to 1.3.2 transaction costs include brokerage (1%), an SFC transaction levy

[125] Tencent Holdings Limited. IPO Prospectus- Hong Kong Public Offering and International Placing.Available: http://globaldocuments.morningstar.com/documentlibrary/document/137bb96118b048a4.msdoc/original [2014, February 27].

(0.005%), an investor compensation levy (0.002%) and a Stock Exchange trading fee (0.005%).
International Placement

2. The company is expected to grant the over-allotment option to International investors, exercised by Goldman Sachs (Asia), the global coordinator, on their behalf.

2.1. This is eligible up to the 30th day after the Listing Date.
2.1.1 As per the company prospectus it was estimated that the Hong Kong Public Offering would become unconditional at or before 08:00 am on Wednesday, 16 June 2004.
2.1.1.1. This indicates that the over-allotment option was exercisable up until Friday, 16 July 2004.
2.1.1.1.1. The associated press announcement of the company exercising the over-allotment option occurred on 5 July 2004.
2.1.1.1.2. The over-allotment shares were expected to be issued on 8 July 2004.
2.1.1.1.3. This was subject to certain conditions between the company and the International Purchasers being met.
2.1.1.1.4. These conditions referred to in 2.1.1.1.3. were set out in the International Purchase Agreement dated 01 June 2004.
2.1.1.1.5. The Listing Committee of the Hong Kong Stock Exchange had already granted the listing of and permission to deal in the over-allotment shares prior to the press announcement.

2.2. Should the over-allotment option occur, a press announcement would be issued by the company.
2.2.1. A press announcement was released on 6 July 2004, indicating that the over-allotment option was exercised on 5 July 2004.

2.3. Should the over-allotment option be exercised, the company will issue and allot up to an aggregate of 63,024,000 additional shares at the offer price. This equates to approximately 15% of the offer shares initially available as per the company prospectus.
2.3.1. The confirmed offer price was at the top of the HK$2.77 – HK$3.70 price range, confirmed at HK$3.70 per offer share.

2.3.2 The additional offer shares would be sold on the same terms & conditions as per the initial offer shares as outlined in the company prospectus.

2.4. The global coordinator, Goldman Sachs (Asia) will cover the additional shares offered through a stock borrowing arrangement.
2.4.1. This stock borrowing arrangement was between Ma Huateng's BVI incorporated company, Advance Data Services Limited (Advance Data Services), and Goldman Sachs.
2.4.2. The over-allotment shares would be returned and redelivered to Advanced Data Services at a later time period.

2.5. Should the total number of shares on offer by the company be reduced, the over-allotment option will be reduced accordingly.
2.5.1. In this instance, the over-allotment option will represent no more than 15% of such reduced number of offer shares.

Exhibit 3: Distribution of Offer Shares Issued to Shareholders [126]

Table Representing the Number of Offer Shares and Percentage of Share Capital Issued by Tencent Holdings Limited				
	Issued Offer Shares (Exclusive of Over-Allotment Option).		Issued Offer Shares (Inclusive of Over-Allotment Option).	
Shareholders	**Number of Shares Issued.**	**Percentage of Share Capital Issued (Approximation)**	**Number of Shares Issued.**	**Percentage of Share Capital Issued (Approximation)**
MIH QQ (BVI) Limited	630,240,380	37.50%	630,240,380	36.14%
Advance Data Services Limited(1)	242,483,080	14.43%	242,483,080	13.91%
Best Update International Limited	108,085,530	6.43%	108,085,530	6.20%
Public Shareholders	420,160,500	25.00%	483,184,500	27.71%
Other Shareholders(2)	279,671,770	16.64%	279,671,770	16.04%
Total	1,680,641,260	100.00%	1,743,665,260	100.00%

Notes

(1) This includes the 63,024,000 Shares lent by Advance Data Services to Goldman Sachs in relation to the stock borrowing arrangements in order to effectively meet the share requirments associated with the Over-Allotment option.

(2) Other Shareholders' refer to the BVI-incorporated wholly owned holding companies of Tencent's remaining core founders. This excludes both Ma Huateng's Advance Data Services Limited, and Zhang Zhidong's Best Update International Limited as referred to seperately in this table.

[126] Tencent Holdings Limited. IPO Prospectus- Hong Kong Public Offering and International Placing.Available: http://globaldocuments.morningstar.com/documentlibrary/document/137bb96118b048a4.msdoc/original [2014, February 27].

Appendix C: The Listing Decision – A Strategic Rationale for Tencent's IPO

Exhibit 1: IPO Listing Requirements of the NASDAQ National Market – Financial and Liquidity Requirements [127]

National Market listing applicants must meet the following financial and liquidity requirements:

1. **Entry Standard 1 - The Income Standard**

→ The issuer of the security must have had an annual income from continuing operations of at least US$1 million (before income taxes) in the most recently completed fiscal year or in two of the last three most recently completed fiscal years.

→ The total amount of the applicant's publicly held shares must equate to at least 1.1 million shares.

→ The market value of the applicant's publicly held shares must be to the value of at least US$8 million.

→ The minimum bid price per share is US$5.

→ The shareholders' equity of the applicant must be to the value of at least US$15 million.

→ The applicant should have a total minimum of 400 shareholders (round lot holders).

→ The applicant must have at least 3 registered and active market makers.

2. **Entry Standard 2 - The Equity Standard**

→ The shareholders' equity of the applicant must be to the value of at least US$30 million.

→ The total amount of the applicant's publicly held shares must equate to at least 1.1 million shares.

[127] SEC.2003. *NASDAQ – Marketplace Rules 4000 Series.*Available: http://www.sec.gov/rules/other/nasdaqllcf1a4_5/nasdaqllcamendrules4000.pdf [2014, April 05].

→ The market value of the applicant's publicly held shares must be to the value of at least US$18 million.

→ The minimum bid price per share is US$5.

→ The applicant must have at least 3 registered and active market makers.

→ The applicant should have an operating history of at least 2 years.

→ The applicant should have a total minimum of 400 shareholders (round lot holders).

3. **Entry Standard 3 - The Market Value Standard**

→ The total amount of the applicant's publicly held shares must equate to at least 1.1 million shares.

→ The market value of the applicant's publicly held shares must be to the value of at least US$20 million.

→ The minimum bid price per share is US$5.

→ The applicant must have at least 4 registered and active market makers.

→ The applicant should have a total minimum of 400 shareholders (round lot holders).

→ The applicant has:

(1) A market value of listed securities of US$75 million (currently traded issuers must meet this requirement and the minimum bid price requirement of US$5 share for a consecutive 90-day period prior to applying for listing).[128]

(2) Total assets and total revenues of US$75 million each for the most recently completed fiscal year, or two of the last three most recently completed fiscal years.

[128] Listed securities are defined as securities that are already listed on the NASDAQ or an alternative North American securities exchange.

Exhibit 2: Table Showing the Differences in Shareholder Protection Rights between the BVI Act and Cayman Island Law [129]

BVI Act	Cayman Island Law	Possible alterations/changes to be made by BVI Incorporated companies in order to comply with the Provision to Rule 19.05(1)
Alteration to the constitutional documents may be effected by majority vote of resolution of members or the directors if authorised by the memorandum.	Alteration can only be made by special resolutions.	To specify that directors do not have power to amend the constitutional documents and that any alteration must be approved by members' special resolution.
The concept of share capital no longer exists and hence no mechanism for increasing share capital.	Authorised share capital can be increased if permitted by a company's articles and effected by ordinary resolution.	To state the maximum number of shares and provide for the increase of shares by majority vote.
The concept of share capital and maintenance no longer exist. Hence, no mechanism for reduction of capital.	Share capital can be reduced if permitted by the company's articles and effected by special resolution of members.	In line with Cayman Island Law, to specify that any distribution must be approved by special resolution of members the same way as that in the Cayman Islands Law.
While the Act does not specify the funding sources for redemption and share repurchase, its solvency test provides that any company may only effect the repurchase if the value of its assets exceeds its liabilities and it is able to pay its debts.	Shares may be repurchased if permitted by the company's articles subject to the company being able to pay its debts.	As the solvency test has limited the BVI company's funding sources for redemption and share repurchase, the position in BVI should be comparable to that of Cayman Islands. The mechanism of repurchase could be done by way of amending the BVI company's memorandum and articles of association (M&A) in the same way as a Cayman Island applicant does to its M&A.
A company can make a distribution from any available source.	Dividends may be paid out of profits or the share premium account.	No amendments needed as the BVI company cannot make a distribution when insolvent under the Solvency Test. The company can only make a distribution when its assets exceed liabilities. Shareholder and creditor protection are in place.

[129] HKEx. 2007. *Joint Policy Statement Regarding the Listing of Overseas Companies.*Available: http://www.acga-asia.org/public/files/listingofoverseascompanies_statement_070307.pdf [2014, April 05].
HKEx. 2009b. *HKEx Listing Decision: HKEx-LD84-1 (December 2009).*Available: http://www.hkex.com.hk/eng/rulesreg/listrules/listdec/documents/ld84-1.pdf [2014, April 05].

Exhibit 3: Initial Listing Fees and Annual Listing Fees Associated with Listing on the HKEx Main Board and NASDAQ National Market [130]

Equity Market Listing Fees		
Hong Kong Stock Exchange	**Value of Equities Listed (HK$)**	**Initial Fee (HK$)**
	Not Exceeding - 100 million	150,000
	Not Exceeding - 200 million	175,000
	Not Exceeding - 300 million	200,000
	Not Exceeding - 400 million	225,000
	Not Exceeding - 500 million	250,000
	Not Exceeding - 750 million	300,000
	Not Exceeding - 1,000 million	350,000
	Not Exceeding - 1,500 million	400,000
	Not Exceeding - 2,000 million	450,000
	Not Exceeding - 2,500 million	500,000
	Not Exceeding - 3,000 million	550,000
	Not Exceeding - 4,000 million	600,000
	Not Exceeding - 5,000 million	600,000
	5,000 million +	650,000
NASDAQ National Market	**Number of Shares Made Available**	**Initial Fee (US$)**
	Up to 30 million shares	100,000
	Between 30 to 50 million shares	125,000
	Over 50 million shares	150,000

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HKEx. 2008a. *Amendments to Main Board Listing Rules: Note to Subscribers for the Amendments to the Rules Governing the Listing of Securities (the "Listing Rules") Update No. 87.* Available: https://www.hkex.com.hk/eng/rulesreg/listrules/mbrulesup/mb_rupdate9_cover.htm [2014,

HKEx. 2008b. *Initial Listing Fees.*Available: https://www.hkex.com.hk/eng/listing/listreq_pro/listing_fees.htm [2014, August 25].

HKEx. 2009a. *Amendments to Main Board Listing Rules: Note to Subscribers for the Amendments to the Rules Governing the Listing of Securities (the "Listing Rules") Update No. 93.*Available: https://www.hkex.com.hk/eng/rulesreg/listrules/mbrulesup/mb_rupdate15_cover.htm [2014, August 25].

HKEx. 2009b. *HKEx Listing Decision: HKEx-LD84-1 (December 2009).*Available: http://www.hkex.com.hk/eng/rulesreg/listrules/listdec/documents/ld84-1.pdf [2014, April 05].

HKEx. 2014b. *Annual Listing Fees.*Available: https://www.hkex.com.hk/eng/listing/listreq_pro/annual_listing_fees.htm [2014, August 25].

HKEx. 2014a. *Amendments to Main Board Listing Rules.*Available: https://www.hkex.com.hk/eng/rulesreg/listrules/mbrulesup/mb_ruleupdate.htm [2014, August 25].

SEC.2003. NASDAQ – Marketplace Rules 4000 Series.Available: http://www.sec.gov/rules/other/nasdaqllcf1a4_5/nasdaqllcamendrules4000.pdf [2014, April 05].

Non-Refundable Application Fee	
Hong Kong Stock Exchange	**Fee (HK$)** Not Applicable
NASDAQ National Market	**Fee (US$)** 5,000

Annual Exchange Fees		
Hong Kong Stock Exchange	**Value of Equities Listed (HK$)**	**Annual Listing Fee (HK$)**
	Not Exceeding - 200 million	145,000
	Not Exceeding - 300 million	172,000
	Not Exceeding - 400 million	198,000
	Not Exceeding - 500 million	224,000
	Not Exceeding - 750 million	290,000
	Not Exceeding - 1,000 million	356,000
	Not Exceeding - 1,500 million	449,000
	Not Exceeding - 2,000 million	541,000
	Not Exceeding - 2,500 million	634,000
	Not Exceeding - 3,000 million	726,000
	Not Exceeding - 4,000 million	898,000
	Not Exceeding - 5,000 million	1,069,000
	5,000 million +	1,188,000
NASDAQ National Market	**Total Number of Shares Outstanding**	**Annual Listing Fee (US$)**
	Up to 10 million shares	24,500
	Between 10 to 25 million shares	30,500
	Between 25 to 50 million shares	34,500
	Between 50 to 75 million shares	44,500
	Between 75 to 100 million shares	61,750
	Over 100 million shares	75,000

Assessment Fees	
Hong Kong Stock Exchange	Not Applicable
NASDAQ National Market	Not Applicable

Appendix D: A Complex Valuation of the Tencent IPO

Exhibit 1: Competitor History

SINA Corporation (NASDAQ: SINA) [131]

Incorporated in the Cayman Islands on 9 July 1997, SINA Corporation (SINA Corp) is a leading online media outlet and value-added information services (VAS) provider in China. Since 20 April 2000 the company has been publicly listed on the US-based NASDAQ Stock Market (NASDAQ: SINA). SINA Corp serves both a local Chinese target market while encompassing the Greater China region and emigrating Chinese citizens. SINA Corp's head office is located in Shanghai, PRC, and is the company's only office to date.

As at financial year-end 31 December 2003 the company employed 785 employees. It was the first Chinese website allowed to publish public news online, while being the first Chinese technology company to offer double-zero convertible bonds valued at US$100 million.

SINA Corp has five principal lines of business:

- SINA.com: Online news and content
- SINA Mobile: Mobile value-added services
- SINA Online: Community-based services and games
- SINA.net: Search and enterprise services
- SINA E-commerce: Online shopping & auctions

Out of its five principal lines of business, SINA Mobile is the largest overall contributor to

[131] SINA Corporation. 2003. *SINA Corporation Annual Report 2003*.Available: http://corp.sina.com.cn/chn/Annual_Report_2003_Final.pdf [2014, April 16].

revenue, followed by SINA.com. Furthermore, of these total revenues, the company achieves its turnover primarily through non-advertising operations. Each business segment's offerings are tailored in accordance with the geographic location of each user. This means that the relevant content displayed is specifically relevant to the region as per the user's location. By the end of 2003, SINA Corp was considered as the most recognized internet brand name in the PRC and by the global Chinese community. Overall the company had approximately 94.8 million registered worldwide users in 2003 upon which its value-added service offerings boasted an active user base exceeding 10 million users during this period.

Geographically SINA Corp has significant market presence in China, Hong Kong, Taiwan, the United States and the rest of the world. Its product portfolio includes online web portals, MVAS, search and directory, interest-based and community-building channels, free and premium email, online games, virtual ISP, classified listings, fee-based services, e-commerce and enterprise e-solutions.

The company's primary MVAS offering is its short messaging service (SMS). It additionally offers multi-media messaging services (MMS), interactive voice response services (IVRS) and wireless application protocol (WAP). In its enterprise service department, SINA Corp appeals to corporate clients through its paid search and directory listings, corporate email services, classified listings, e-learning and enterprise solutions. As at the end of the 2003 financial year, SINA began the phasing out process of its 'Software revenue' division. This division did not prove feasible for the company and was removed.

To secure its MVAS offerings SINA Corp has established cooperation arrangements with China's largest mobile phone operators, China Mobile and China Unicom. The company has also partnered with a variety of multinational companies in a diverse set of industries by entering into various joint ventures, acquisition agreements and sponsorship contracts. SINA Corp has been awarded numerous awards since founding on 9 July 1997.

Sohu.com Inc. (NASDAQ: SOHU) [132]

Incorporated in the Cayman Islands in August 1996, Sohu.com Inc. (Sohu) is a leading provider of online products and services to consumers and businesses in China. Since 21 July 2000 the company has been publicly listed on the NASDAQ Stock Market (NASDAQ: SOHU).The company is considered as the pioneer of China's internet industry, deemed as the first internet portal in China. The company has offices in Hong, Kong, Shanghai and Guangzhou while its head office is in Beijing, PRC. As at financial year-end 31 December 2003 it employed 1016 employees.

Sohu.com's business model accommodates both corporates and consumers, upon which it holds competitive positions in both market segments. Sohu boasts a retail client-base of 55,000 lending to its early mover advantage in the sponsored search space through its 'Search Fox' offering. Sohu was also considered one of the top two Chinese web portals in 2003, yielding a strong competitive advantage in industry. The company believes this position makes it an attractive brand-advertising platform for its corporate clients and will yield strong revenues for the firm as online advertising transforms the traditional Chinese advertising space in the near future.

Sohu has five principal lines of business:

- Sohu.com: Mass portal & online media destination
- Sms.sohu.com: E-subscriptions & Wireless services for mobile phone users.
- Chinaren.com: Youth community
- 17173.com: Games information portal
- Focus.cn: Real estate

The company generates its revenues by offering advertising and non-advertising content. Non-advertising content includes specifically e-subscription and e-commerce services, wireless, internet access and multiplayer online game services.

[132] Sohu. 2003b. *Sohu Annual Report 2003.*Available: http://files.shareholder.com/downloads/ABEA-4Z99DA/3131732366x0x662302/1B6ADA5A-25A6-4D51-ADFF-D665C74CC6AE/2003_Annual_Report.pdf [2014, April 16].

Geographically Sohu.com focuses solely on China upon which its product and services have been carefully constructed to cater for the unique viewing habits of Chinese internet users. The company's product portfolio consists of providing sophisticated Chinese language web navigational and search capabilities, 20 main content channels, web-based communications, alumni club, community services, an e-commerce platform, wireless and multiplayer online game services. In addition to this, Sohu also attracts users through its free web-based email offering, while also providing a paid-for email service along with additional perceived benefits. These channels encompass a diverse nature of aggregated content amidst the likes of news, sport, women, information technology, business & finance, entertainment, music, automobile, real estate, dating, health, travel, learning, career, going abroad, lifestyle, games, auction and recruitment.

Sohu has entered into a variety of online partnerships with top, reputable multinational brands of both an Eastern and Western nature. The company has entered into contracts with China's largest mobile operators, China Mobile and China Unicom to ensure it can effectively offer its MVAS services. Furthermore, it has entered into a joint marketing campaign with China Mobile and mobile handset manufacturer Motorola.

NetEase Inc. (NASDAQ: NTES) [133]

Incorporated in the Cayman Islands on 6 July 1997, NetEase Inc (NetEase) is a major provider of Chinese language content and services through its online games, wireless value-added services and internet portal. The company operates a leading interactive and online wireless community in China. Since 7 July 2000 NetEase has been publicly listed on the NASDAQ Stock Market (NASDAQ: NTES). NetEase is among the first of its kind to offer e-mail, virtual communities and free web hosting in China. It is also considered as one of the founding contributors of China's online gaming industry, developing and introducing one of the first large-scale Chinese online games 'Westward Journey Online' in August 2002.

The company has offices in Shanghai and Guangzhou while its Head Office is in Beijing, PRC. As at financial year-end 31 December 2003, NetEase had approximately 167 million registered user accounts, with average daily page views exceeding 290 million for the month ending 31 December 2003. On this date the company employed 620 employees.

NetEase has three principal lines of business:

- MMORPG Online Game Services
- Advertising Services
- Wireless value-added services & other fee-based premium services

As at 31 December 2003 NetEase boasted an average of 171,000 concurrent online game users and a total of 1.7 million unique paying visitors for the December month alone. By the end of the 2003 financial year it was expected that NetEase's online gaming services would become the industry leader in China's online gaming industry.

Wireless value-added services include providing news, stock quotes, email, ringtone & logo downloads, matchmaking and interactive games. Primarily wireless value-added services are in the form of short messaging services (SMS), providing news and information subscription

[133] NetEase. 2003. *NetEase Annual Report 2003.*Available: http://media.corporate ir.net/media_files/IROL/12/122303/docs/netease_2003.pdf [2014, April 16].

services, interactive and community services, internet-related services and media downloading services. While relatively new technologies, NetEase did offer multi-media messaging services (MMS), interactive voice response services (IVRS) and wireless application protocol (WAP) at this time.

NetEase's internet portal focusses on three main areas, providing Chinese language online services in content, community & communication and commerce. Content is distributed through 21 channels and includes news, entertainment, sports, finance, information technology, automobiles, astrology and cartoons. In addition, region-based content is provided in accordance with a user's geographic location. Geographically NetEase only operates within China itself, ensuring region-based content is relevant only to users in the cities of Guangdong and Shanghai.

Other web services include free and paid-for email, instant messaging, personal advertising, matchmaking, alumni directories, personal homepages, clubs, e-cards, chat rooms, community forums, web directories, web search services, classified advertisements, banner advertising, e-mail advertising, interactive media-rich advertising, special event advertising, games & contest advertising as well as an online shopping and e-commerce platform.

NetEase has entered into arrangements with China's largest mobile phone operators, China Mobile and China Unicom to ensure it offers an expansive range of MVAS offerings. NetEase's Internet portal content is both user-generated and in-house developed, ensuring that the company's content is relevant and suitable to meet the needs and tastes of its users in such a fast-paced market environment.

TOM Online (NASDAQ: TOMO, GEM Stock Code: 8282) [134]

Founded in June 1997 and incorporated in the Cayman Islands on 28 August 2001, TOM Online Inc (TOM) is a leading wireless internet company in China, specializing in value-added multimedia products and services. Since March 2004 TOM has been publicly dual-listed on both the US-based NASDAQ Stock Market and the Hong Kong Stock Exchange Growth Enterprise Market (GEM). TOM was initially listed on the NASDAQ Stock Market on 10 March 2004 (NASDAQ: TOMO) and the GEM on 11 March 2004 (GEM Stock Code: 8282). The company was the first in industry to dual-list.

Tom Online is a subsidiary of the TOM Group, representing the group's internet sector amongst its outdoor media, publishing, sports and television & entertainment segments. The TOM Group is one of the leading Chinese language media groups in the Greater China region, and is solely operable in this geographic space only. Within this region, it aims to attract the young and trendy Chinese consumer through its product offerings. TOM Online has offices in Hong Kong while its head office is in Beijing, PRC. As at financial year-end 31 December 2003 the company employed 440 employees.

TOM Online has four principal lines of business:

- Wireless value-added internet services
- Commercial enterprise solutions
- Advertising (Online & Offline)
- Internet Access

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Bloomberg. 2014c. TOM Online IPO Prospectus. Available: Bloomberg subscription service [2014, April 07].
TOM Online Prospectus. 2004. *TOM Online- Listing on The Growth Enterprise Market of The Stock Exchange og Hong Kong Limited.*Available: http://www.hkexnews.hk/listedco/listconews/SEHK/2004/0629/LTN20040629049.htm [2014, April 09].
TOM Online. *Milestones.*Available: http://ir.tom.com/en/milestone.html [2014, April 11].
TOM Online. 2004. *TOM Online Annual Report*. Available: http://pr.tom.com/pdf/EW08282_report_2004fy.pdf [2014, July 23].

TOM Online's primary operating segment was its IVAS/MVAS division.This was followed byits commercial enterprise solutions, advertising and internet access. This is the result of its partnership with China's largest mobile networks, China Mobile and China Unicom. The platforms offered by these companies ensure that TOM is able to provide short messaging services (SMS) and the likes of multi-media messaging services (MMS), interactive voice response services (IVRS), wireless application protocol (WAP) and ringback tone services in the future.

The company's commercial enterprise solutions are centered on providing retail clients with internet-related technical and consulting services while offering direct access to purchase and installation of computer hardware. As at the beginning of the 2004 financial year this segment was in the process of being phased out. This was in addition to its internet access segment which ceased operations in the fourth quarter of 2002. Additional company offerings include distributing entertainment, sport and music content to mobile phones, online search functionality, online classifieds, content channels and both free and fee-based advanced email services. The company began to explore the online gaming space with its 'Karma Online' offering; however this has not proved fruitful.

Tom Online has formed strategic partnerships with mobile handset manufacturers Nokia and Motorola, while ranked as the fourth most popular internet portal in China. It is also ranked as one of the top three Chinese internet portals for women's entertainment and sports channels.

Exhibit 2: Consolidated Statement of Operations & Consolidated Statement of Financial Position of Tencent Holdings Limited, SINA Corp, Sohu.com, NetEase and TOM Online for the Financial Year Ending 31 December 200X

Tencent Holdings Limited - Consolidated Statement of Operations for the year ended 31 December 200X

	2003	2002	2001	2003	2002	2001
	USD'000	USD'000	USD'000	RMB'000	RMB'000	RMB'000
Revenues:						
Mobile and telecommuncation value-added services	56 466	24 021	4 586	467 369	198 818	37 960
Internet value-added services	27 750	4 932	114	229 690	40 819	944
Online advertising	3 968	2 318	935	32 841	19 188	7 735
Others	611	517	294	5 057	4 282	2 437
	88 795	31 788	5 929	734 957	263 107	49 076
Cost of revenues	(27 733)	(8 659)	(2 180)	(229 548)	(71 674)	(18 044)
Gross profit	61 062	23 128	3 749	505 409	191 433	31 032
Other operating (expenses)/income, net	(148)	(29)	(10)	(1 226)	(242)	(82)
Selling and marketing expenses	(6 762)	(2 348)	(521)	(55 967)	(19 437)	(4 312)
General and adminsitrative expenses	(13 533)	(3 487)	(1 969)	(112 011)	(28 860)	(16 297)
Operating Profit	40 619	17 264	1 249	336 205	142 894	10 341
Net Finance Costs	242	105	(15)	2 004	871	(125)
Profit before taxation	40 861	17 369	1 234	338 209	143 765	10 216
Taxation	(1 935)	(369)	-	(16 013)	(3 058)	-
Profit for the year/period	38 927	17 000	1 234	322 196	140 707	10 216
Earnings per share						
basic (cents)	0.029	0.013	0.001	0.244	0.104	0.009
diluted (cents)	0.029	0.013	0.001	0.244	0.104	0.008
	-	-	-			
Proposed dividends	3 496	1 249	-	28 935	10 334	-
Proposed dividends per share (RMB)	-	0.001	-	0.023	0.008	-

Tencent Holdings Limited - Consolidated Statement of Financial Position as at 31 December 200X

	2003	2002	2001	2003	2002	2001
	USD'000	USD'000	USD'000	RMB'000	RMB'000	RMB'000
Assets						
Non-current assets						
Fixed assets	9,682	4,694	2,038	80,139	38,851	16,868
Deposit in connection with the formation of Shiki Kaixuan Technology	1,329	-	-	11,000	-	-
	11,011	4,694	2,038	91,139	38,851	16,868
Current assets						
Accounts receivable	12,049	7,140	1,027	99,726	59,094	8,500
Amounts due from shareholders	10	10	10	82	82	82
Prepayments, deposits and other receivables	4,334	356	45	35,872	2,945	369
Term deposits with initial term of over three months	2,816	8,148		23,311	67,440	-
Cash and cash equivalents	39,336	5,467	4,799	325,586	45,254	39,723
	58,545	21,121	5,881	484,577	174,815	48,674
Total assets	69,556	25,814	7,918	575,716	213,666	65,542
Equity and liabilities						
Current liabilities						
Other payables and accruals	7,165	437	637	59,301	3,615	5,273
Amounts due to shareholders	-	-	1,078	-	-	8,919
Amounts due to related parties	-	181	-	-	1,499	-
Dividends payable	-	-	-	-	-	-
Income taxes payable	860	-	-	7,115	-	-
Other taxes payable	3,948	848	366	32,679	7,021	3,026
Deferred revenue	444	63	-	3,676	523	-
	12,416	1,529	2,080	102,771	12,658	17,218
Non-current liabilities	-	-	-			
Deferred tax liabilities	119	369	-	988	3,058	-
Total liabilities	12,536	1,899	2,080	103,759	15,716	17,218
Shareholders' equity	-	-	-			
Share capital	17	18	18	138	149	146
Reserves	57,004	23,898	5,821	471,819	197,801	48,178
Total shareholders' equity	57,020	23,916	5,838	471,957	197,950	48,324
Total liabilities and shareholders' equity	69,556	25,814	7,918	575,716	213,666	65,542

SINA Corporation - Consolidated Statement of Operations for the year ended 31 December 200X

	2003	2002	2001
	USD'000	USD'000	USD'000
Revenues:			
Advertising	41,173	24,703	23,393
Non-advertising	73,112	14,191	3,290
	114,285	38,894	26,683
Cost of revenues:			
Advertising	14,001	11,267	13,771
Non-advertising	20,405	4,140	1,169
Stock-based compensation	31	102	414
	(34,437)	(15,509)	(15,343)
Gross profit	79,848	23,385	11,329
Operating expenses:			
Sales and marketing	21,741	12,419	21,694
Product development	6,340	5,916	9,648
General and administrative	11,551	8,896	8,918
Stock-based compensation*	523	1,692	7,097
Amortization of intangible assets	1,749	1,777	6,765
Write-off intangible assets	903	-	-
Total operating expenses	(42,807)	(30,700)	(54,122)
Operating profit/(loss)	37,041	(7,315)	(42,793)
Other (expenses)/income:			
Interest income	2,757	2,819	7,336
Other expenses	(162)	-	-
Amortization of convertible debt issuance cost	(341)	-	-
Impairment of investments in Sun Media Group	(6,063)	-	-
Loss on equity investments	(914)	(453)	(894)
Net profit/(loss) before taxes	32,318	(4,949)	(36,351)
Income tax expense	(895)	-	-
Net profit (loss)	31,423	(4,949)	(36,351)
Basic net income (loss) per share	0.66	(0.11)	(0.91)
Diluted net income (loss) per share	0.58	(0.11)	(0.91)

**Stock-based compensation was related to the associated expense categories as follows:*

	523	1,692	7,097
Sales and marketing	16	51	-
Product development	168	541	-
General and administrative	339	1,100	-

Note

The 2001 financial year ended on 30 June, 2001. The 2002 financial year has been restated in accordance with the new financial period ending 31 December each year.

SINA Corporation - Consolidated Statement of Financial Position as at 31 December 200X	2003	2002	2001
	USD'000	USD'000	USD'000
Assets			
Current Assets			
Cash and cash equivalents	158,148	53,262	52,505
Short-term investments	69,016	43,474	57,284
Accounts receivable, net	17,606	5,847	4,262
Deferred tax assets	907	-	
Prepaid expenses and other current assets	4,579	2,323	1,350
Total current assets	250,256	104,906	115,401
Non-current assets			
Investment in Sun Media Group	6,793	16,637	
Property and equipment, net	8,646	7,599	11,911
Long-term investments	2,085	-	-
Intangible assets, net	569	993	5,063
Goodwill	18,091	-	556
Other assets	3,457	344	191
Total assets	289,897	130,479	133,122
Liabilities and Shareholder's Equity			
Current liabilities			
Accounts payable	1,147	1,345	1,613
Accrued liabilities	27,442	11,747	11,542
Incomes taxes payable	1,801	-	-
Total current liabilities	30,390	13,092	13,155
Non-current liabilities			
Convertible debt	100,000	-	-
Total liabilities	130,390	13,092	13,155
Commitments and contingencies (Note 16)			
Shareholder's equity			
Ordinary Shares: US$0.133 par value; 75,000,000 shares authorized; 48,627,000 and 45,946,000 shares issued and outstanding	6,471	6,114	5,504
Additional paid-in capital	236,222	223,358	220,671
Ordinary shares subject to subsequent issuance: 177,000 shares	1,349	-	-
Notes receivable from shareholders	-	(1,050)	(1,479)
Deferred stock compensation	-	(554)	(5,423)
Accumulated deficit	(83,054)	(114,477)	(99,301)
Accumulated other comprehensive income (loss):			
Unrealized gain (loss) or investment in marketable securities	(1,510)	4,004	-
Cumulative translation adjustments	29	(8)	(5)
Total shareholders' equity	159,507	117,387	119,967
Total liabilities and shareholders' equity	289,897	130,479	133,122

Note

The 2001 financial year ended on 30 June, 2001. The 2002 financial year has been restated in accordance with the new financial period ending 31 December each year.

Sohu.com - Consolidated Statement of Operations for the year ended 31 December 200X	2003	2002	2001
	USD'000	USD'000	USD'000
Revenues:			
Advertising (including US$0, US$0, and US$962 from related parties)	29,503	13,852	9,245
Non-advertising:			
Wireless / E-subscription (including US$19,789 , US$10,132 and US$1,252 from related parties)	47,053	10,132	1,252
E-commerce (including US$1,899 , US$3,546 and US$1,529 of related party services)	3,787	4,201	1,703
Other	82	544	800
Subtotal of non-advertising revenues	50,922	14,877	3,755
Total revenues	80,425	28,729	13,000
Cost of revenues:			
Advertising (including US$72, US$145, and US$181 from related parties)	7,459	5,943	6,644
Non-advertising:			
E-subscription (including US$6,193 , US$3,655 and US$587 from related parties)	14,336	3,655	587
E-commerce (including US$1,899 , US$3,546 and US$1,529 of related party services)	3,411	3,546	1,529
Other	-	280	653
Subtotal of non-advertising cost of revenues	17,747	7,481	2,769
Total cost of revenues	25,206	13,424	9,413
Gross profit	55,219	15,305	3,587
Operating Expenses:			
Product development	7,542	5,508	5,365
Sales and marketing (including US$0, US$0 and US$44,3 related party services)	10,570	7,973	8,406
General and administrative	5,029	3,908	4,792
Amortization of intangibles	57	-	12,607
Impairment of intangibles	-	-	17,676
Total operating expenses	23,198	17,389	48,846
Operating profit/(loss)	32,021	(2,084)	(45,259)
Other income (expenses):			
Other expense	(964)	(217)	(594)
Interest income	1,950	1,265	2,176
Net profit/(loss) before taxes	33,007	(1,036)	(43,587)
Income tax expense	(6,650)	-	-
Net profit (loss)	26,357	(1,036)	(43,587)
Basic net income/(loss) per share	0.74	(0.03)	(1.22)
Shares used in computing basic net income/(loss) per share	35,483	35,420	35,626
Diluted net income/(loss) per share	0.66	(0.03)	(1.22)
Shares used in computing diluted net income/(loss) per share	40,351	35,420	35,626

Sohu.com - Consolidated Statement of Financial Position as at 31 December 200X	2003	2002	2001
	USD'000	USD'000	USD'000
Assets			
Current Assets			
Cash and cash equivalents	99,109	18,929	29,263
Accounts receivable, net	12,381	1,992	2,710
Accounts receivable from a related party	-	1,962	-
Prepaid and other current assets	5,040	2,009	2,168
Current portion of long-term investments in marketable debt securities	29,245	2,482	-
Total current assets	144,785	27,374	34,141
Non-current assets			
Long-term investments in marketable debt securities	14,216	22,800	16,973
Fixed assets, net	6,846	6,012	7,953
Long-term loans to related parties	-	4,827	1,815
Goodwill	31,664	-	-
Intangible assets, net	4,082	-	-
Other assets, net	3,462	959	1,076
Total Assets	205,055	61,972	61,958
Liabilities and Shareholder's Equity			
Current liabilities			
Accounts payable	1,101	977	366
Payable to related parties	-	1,455	1,208
Accrued liabilities	22,315	4,309	2,803
Total current liabilities	23,416	6,741	4,377
Zero coupon convertible senior notes	90,000	-	-
Total liabilities	113,416	6,741	4,377
Commitments and contingencies (Note 10)			
Shareholder's equity			
Common Stock: US$0.001 par value per share (75,400 authorized, 36,101 and 34,611 shares issued and outstanding at December 31, 2003 and 2002)	36	35	36
Treasury Stock	(2,003)	(2,003)	-
Additional paid-in capital	140,218	129,881	129,852
Deferred compensation	(14)	(42)	(156)
Accumulated other comprehensive income	232	547	-
Accumulated deficit	(46,830)	(73,187)	(72,151)
Total shareholders' equity	91,639	55,231	57,581
Total liabilities and shareholders' equity	205,055	61,972	61,958

NetEase - Consolidated Statement of Operations for the year ended 31 December 200X						
	2003	2002	2001	2003	2002	2001
	USD'000	USD'000	USD'000	RMB'000	RMB'000	RMB'000
Revenues:						
Online game services	24,556	4,475	-	203,246	37,053	-
Wireless value-added and other fee-based premium services	33,789	19,481	1,706	279,659	161,306	14,136
Advertising services	10,413	4,132	1,711	86,184	34,209	14,164
	68,758	28,088	3,417	569,089	232,568	28,300
Business tax	(3,257)	(1,404)	(275)	(26,955)	(11,627)	(2,275)
Net revenues	65,501	26,684	3,142	542,135	220,941	26,026
Cost of revenues	(10,326)	(8,659)	(7,256)	(85,463)	(71,678)	(60,058)
Gross profit (Loss on revenues)	55,176	18,025	(4,114)	456,672	149,264	(34,033)
Operating expenses:						
Selling, general and administrative expenses	(13,383)	(11,206)	(21,937)	(110,770)	(94,308)	(181,765)
Research and development expenses	(2,310)	(1,668)	(1,350)	(19,121)	(14,185)	(13,323)
Asset impairment loss	-	(90)	(334)	-	(747)	(2,767)
Class action settlement	-	(4,348)	-	-	(36,005)	-
Total operating expenses	(15,694)	(17,542)	(23,905)	(129,891)	(145,245)	(197,854)
Operating profit (loss)	3,948	483	(28,019)	326,781	4,019	(231,887)
Other income (expenses):						
Investments impairment loss	-	-	(1,078)	-	-	(8,924)
Investment income	65	-	-	538	-	-
Interest income	1,362	913	2,123	11,274	7,562	17,571
Interest expenses	-	(169)	(1,194)	-	(1,401)	(9,883)
Other, net	654	450	(5)	5,410	3,725	(41)
Profit (Loss) before tax	41,563	1,677	(28,173)	344,003	13,906	(233,164)
Income tax benefit (expense)	(2,553)	289	-	(21,130)	2,396	-
Net profit (loss)	39,010	1,966	(28,173)	322,873	16,302	(233,164)
Other comprehensive income (loss)						
Currency translation adjustments	(2)	1	68	(18)	12	566
Comprehensive income (loss)	39,008	1,970	(28,105)	322,855	16,313	(232,598)
Net earnings (loss) per share, basic	0.01	0.01	(0.01)	0.10	0.01	(0.08)
Net earnings (loss) per ADS, basic	1.25	0.06	(0.93)	10.34	0.53	(7.74)
Net earnings (loss) per share, diluted	0.01	0.01	(0.01)	0.10	0.01	0.08
Net earnings (loss) per ADS, diluted	1.18	0.06	(0.93)	9.78	0.52	7.74
Weighted average number of ordinary shares outstanding, basic	3,122,258	3,051,395	3,013,419	3,122,258	3,051,395	3,013,419
Weighted average number of ADS outstanding, basic	31,223	30,514	30,134	31,223	30,514	30,134
Weighted average number of ordinary shares outstanding, diluted	3,301,311	3,127,838	3,013,419	3,301,311	3,127,838	3,013,419
Weighted average number of ADS outstanding, diluted	33,013	31,278	30,134	33,013	31,278	30,134
Share compensation cost included in:						
Cost of revenues	-	(230)	-	-	(1,908)	-
Selling, general and administrative expenses	-18 19/72	(184)	(24,699)	(151)	(1,522)	(204)
Research and development expenses	(11)	(45)	(260,171)	(88)	(376)	(2,153)
	(29)	(459,766)	(284,870)	(29)	(3,807)	(2,358)

NetEase - Consolidated Statement of Financial Position as at 31 December 200X	2003	2002	2001	2003	2002	2001
	USD'000	USD'000	USD'000	RMB'000	RMB'000	RMB'000
Assets						
Current assets						
Cash	163,841.81	67,641.27	57,947.53	1,356,070	560,070	479,609
Restricted cash	-	146	10,911.30	-	1,208	90,308
Held-to-maturity investments	40,123.91	-		332,094	-	
Temporary cash investments	-	-	5,500.00	-	-	45,521
Prepayments and other current assets	2,386.14	738.01	1,103.88	19,749	6,111	9,136
Due from related parties, net of allowance for doubtful accounts of RMB8,703,307 and RMB10,157,789 (US$1,227,275) at December 31, 2002 and 2003, respectively.	1,834.38	2,711	276.71	15,183	22,449	2,290
Deferred tax assets	1,168.28	-	-	9,670	-	-
Total current assets	209,354.52	71,236.38	75,739.42	1,732,765	589,837	626,865
Non-current assets						
Rental deposit	172.84	128.73	131.39	1,431	1,066	1,087
Investment in convertible preference shares		-	1,172.14	-	-	9,701
Property, equipment and software, net	4,882.41	3,185.89	4,392.64	40,410	26,379	36,356
Deferred tax assets	-	289.36	-	-	2,396	-
Deferred assets	1,460.33	-	94.65	12,087	-	783
Total non-current assets	6,515.58	3,603.98	5,790.81	(53,928)	29,841	47,931
Total assets	215,870.10	74,840.36	81,530.23	1,786,692	619,678	674,793
Liabilities and Shareholders' Equity						
Current liabilities						
Short-term bank loans	-	-	10,149	-		84,000
Accounts payable	1,297	461	1,585	10,738	3,815	13,116
Salary and welfare payable	2,103	1,935	1,201	17,406	16,023	1,201
Taxes payable	1,930	997	214	15,976	8,253	214
Deferred revenue	-	20	-	-	165	-
Accrued liabilities	1,413	1,256	1,322	11,699	10,398	1,322
Due to a related party, net	2,652	-	-	21,947	-	-
Total current liabilities	9,396	4,668	14,470	77,766	38,654	14,470
Non-current liabilities						
Zero Coupon Convertible Subordinated Notes due July 15, 2023	100,000	-	-	827,670	-	-
Other long-term payable	28	-	-	231	-	-
Total long-term payable	100,028	-	-	827,901	-	-
Total liabilities	109,424	4,668	14,470	905,668	38,654	14,470
Commitments and contingencies						
Shareholders' equity						
Ordinary shares, US$0.0001 par value: 1,000,300,000,000 shares authorized, 3,100,162,537 shares issued and outstanding as of December 31, 2002 and 3,128,958,189 shares issued and outstanding as of December 31, 2003	313	310	302	2,590	2,567	2,504
Additional paid-in capital	120,006	126,769	126,246	993,255	1,049,651	1,044,890
Less: Subscriptions receivable	-	(3,999)	(4,241)	-	(33,114)	(35,101)
Statutory reserves	4,072	-	-	33,700	-	-
Deferred compensation	(8)	(57)	(404)	(69)	(475)	(3,345)
Translation adjustments	25	28	26	211	229	217
Accumulated deficit	(17,961)	(52,879)	(54,870)	(148,662)	(437,834)	(454,136)
Total shareholders' equity	106,446	70,172	67,060	881,024	581,024	555,030
Total liabilities and shareholders' equity	215.87	74,840	81,530	1,786,692	619,678	674,793

TOM Online - Consolidated Statement of Operations for the year ended 31 December 200X

	2003	2002	2001
	USD'000	USD'000	USD'000
Revenues:			
Wireless internet services	55,843	9,958	30
Advertising	5,845	4,228	2,950
Commercial enterprise solutions	13,825	11,244	1,479
Internet access	1,590	4,545	1,974
Total revenues	77,073	29,975	6,433
Cost of revenues:			
Cost of services	(32,794)	(16,731)	(10,849)
Cost of goods sold	(11,291)	(8,143)	(59)
Total cost of revenues	(44,085)	(24,874)	(10,908)
Gross profit	32,988	5,101	(4,475)
Operating expenses:			
Selling and marketing expenses	(2,772)	(3,069)	(5,755)
General and administrative expenses	(9,133)	(7,356)	(8,808)
Product development expenses	(689)	(692)	(1,085)
Amortization of intangibles	(629)	(88)	(8)
Provision for impairment of goodwill	-	(1,949)	-
Provision for impairment of intangibles	-	(266)	-
Provision for impairment of property and equipment	-	-	(2,960)
Total operating expenses	(13,223)	(13,420)	(18,616)
Operating profit/(loss)	19,765	(8,319)	(23,091)
Other (expenses)/income:			
Net interest (expenses)/income	(320)	(408)	(347)
Net profit/(loss) before taxes	19,445	(8,727)	(23,438)
Income tax expense	254	(16)	-
Net profit (loss)	19,699	(8,743)	(23,438)
Minority interests	(127)	389	294
Net (loss)/income attributable to shareholders	19,572	(8,354)	(23,144)
(Loss)/earnings per ordinary share basic (cents)	0.699	(0.298)	(0.827)
(Loss)/earnings per ordinary share diluted (cents)	-	-	-

TOM Online - Consolidated Statement of Financial Position as at 31 December 200X

	2003	2002	2001
	USD'000	USD'000	USD'000
Assets			
Current Assets			
Cash and cash equivalents	22,636	6,752	5,320
Accounts receivable, net	14,689	8,003	5,370
Deferred costs	15,000	-	-
Restricted cash	-	-	4,030
Prepayments	1,405	1,909	2,545
Deposits and other receivables	935	416	337
Due from related parties	124	460	1,447
Inventories	29	1,522	226
Total current assets	54,818	19,062	19,275
Non-current assets			
Long-term prepayments and deposits	565	994	1,088
Property and equipment, net	7,094	5,518	2,960
Deferred tax assets	274	-	-
Goodwill, net	214	-	1,949
Intangibles, net	4,411	-	354
Total assets	67,376	25,574	25,626
Liabilities and shareholders' equity			
Current liabilities			
Accounts payable	3,241	2,926	2,819
Other payables and accruals	22,195	3,838	5,198
Income tax payable	401	-	-
Deferred revenues	414	1,734	2,813
Consideration payables	6,580	-	-
Due to related parties- short term	-	-	3,615
Total current liabilities	32,831	8,498	14,445
Non-current liabilities			
Due to related parties- long term	19,983	26,316	11,801
Total liabilities	52,814	34,814	26,246
Minority interests	152	224	613
	52,966	35,038	26,859
Commitments			
Shareholders' equity			
Share capital	3,590	3,590	3,590
Paid-in capital	75,551	93,184	93,018
Accumulated other comprehensive losses	(55)	(55)	(12)
Accumulated deficit	(64,676)	(106,183)	(97,829)
Total shareholders' equity	14,410	(9,464)	(1,233)
Total liabilities and shareholders' equity	67,376	25,574	25,626

Exhibit 3: Discounted Cash Flow - Income Statement Showing Percentage Growth per Line Item of Tencent Holdings Limited for the Historical 2001 to 2003Financial Period

INCOME STATEMENT (ACTUAL) (RMB '000) as at 31 December	2001	Year-on-Year	2002	Year-on-Year	2003
Continuing operations:	**RMB'000**	**Growth (%)**	**RMB'000**	**Growth (%)**	**RMB'000**
Mobile and telecommuncation value-added services	37,960	423.76%	198,818	135.07%	467,369
Internet value-added services	944	4224.05%	40,819	462.70%	229,690
Online advertising	7,735	148.07%	19,188	71.15%	32,841
Others	2,437	75.71%	4,282	18.10%	5,057
Total Revenues	49,076	436.12%	263,107	179.34%	734,957
Cost of revenues	(18,044)	297.22%	(71,674)	220.27%	(229,548)
Gross profit	31,032	516.89%	191,433	164.01%	505,409
Other operating (expenses)/income, net	(82)	195.12%	(242)	406.61%	(1,226)
Selling and marketing expenses	(4,312)	350.77%	(19,437)	187.94%	(55,967)
General and adminstrative expenses	(16,297)	77.09%	(28,860)	288.12%	(112,011)
Operating profit	10,341	1281.82%	142,894	135.28%	336,205
Net finance costs	(125)	-796.80%	871	130.08%	2,004
Profit before tax	10,216	1307.25%	143,765	135.25%	338,209
Taxation	-	-	(3,058)	423.64%	(16,013)
Profit for the year from continuing operations	10,216	1277.32%	140,707	128.98%	322,196

Exhibit 4: Discounted Cash Flow - Forecasted Income Statement of Tencent Holdings Limited for the 2004 to 2008 Financial Period

INCOME STATEMENT (FORECAST) (RMB '000)					
as at 31 December	**2003**	**Year-on-Year**	**2004**	**Year-on-Year**	**2005**
Continuing operations:	**RMB'000**	**Growth (%)**	**RMB'000**	**Growth (%)**	**RMB'000**
Mobile and telecommuncation value-added services	467,369	35%	630,948	40%	883,327
Internet value-added services	229,690	39%	319,269	45%	462,940
Online advertising	32,841	32%	43,350	38%	59,823
Others	5,057	21%	6,119	24%	7,588
Total Revenues	734,957	**36%**	999,686	**41%**	1,413,678
Cost of revenues	(229,548)	**58%**	(363,435)	**56%**	(567,106)
Gross profit	505,409		636,251		846,572
Other operating (expenses)/income, net	(1,226)		(3,457)		(10,545)
Selling and marketing expenses	(55,967)		(68,839)		(86,738)
General and adminsitrative expenses	(112,011)		(143,374)		(169,181)
Operating profit	336,205		420,580		580,108
Net finance costs	2,004		2,708		2,915
Profit before tax	338,209		423,288		583,023
Taxation (10.66%)	(16,013)		(45,123)		(62,150)
Profit for the year from continuing operations	322,196	**17%**	378,166	**38%**	520,873

INCOME STATEMENT (FORECAST) (RMB '000)

as at 31 December **Continuing operations:**	**2005** **RMB'000**	**Year-on-Year Growth (%)**	**2006** **RMB'000**	**Year-on-Year Growth (%)**	**2007** **RMB'000**	**Year-on-Year Growth (%)**	**2008** **RMB'000**
Mobile and telecommuncation value-added services	883,327	42%	1,254,325	60%	2,006,920	76%	3,532,179
Internet value-added services	462,940	54%	712,928	77%	1,261,882	95%	2,460,671
Online advertising	59,823	52%	90,931	75%	159,130	84%	292,799
Others	7,588	32%	10,016	38%	13,821	48%	20,456
Total Revenues	1,413,678	**46%**	2,068,200	**66%**	3,441,753	**83%**	6,306,104
Cost of revenues	(567,106)	**97%**	(1,117,326)	**75%**	(1,955,887)	**86%**	(3,637,114)
Gross profit	846,572		950,873		1,485,866		2,668,990
Other operating (expenses)/income, net	(10,545)		(24,253)		(65,483)		(95,606)
Selling and marketing expenses	(86,738)		(145,719)		(269,581)		(539,161)
General and adminsitrative expenses	(169,181)		(247,005)		(276,645)		(298,777)
Operating profit	580,108		533,896		874,157		1,735,446
Net finance costs	2,915		3,182		3,792		4,600
Profit before tax	583,023		537,078		877,949		1,740,046
Taxation (10.66%)	(62,150)		(57,252)		(93,589)		(185,489)
Profit for the year from continuing operations	520,873	**-8%**	479,825	**63%**	784,359	**98%**	1,554,557

Exhibit 5: Discounted Cash Flow - Forecasted Revenues and Cost of Revenues of Tencent Holdings Limited for the 2004 to 2008 Financial Period

Revenues	**49 076**	**263 107**	**734 957**	**999 686**	**1 413 678**	**2 068 200**	**3 441 753**	**6 306 104**
	2001	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**
	RMB'000	**RMB'000**	**RMB'000**	**RMB'000**	**RMB'000**	**RMB'000**	**RMB'000**	**RMB'000**
Mobile and telecommuncation value-added services	37960	198 818	467 369	630 948	883 327	1 254 325	2 006 920	3 532 179
Internet value-added services	944	40 819	229 690	319 269	462 940	712 928	1 261 882	2 460 671
Online advertising	7735	19 188	32 841	43 350	59 823	90 931	159 130	292 799
Others	2437	4 282	5 057	6 119	7 588	10 016	13 821	20 456
Percentage Contribution of Total Costs	77%	76%	64%	63%	62%	61%	58%	56%
	2%	16%	31%	32%	33%	34%	37%	39%
	16%	7%	4%	4%	4%	4%	5%	5%
	5%	2%	1%	1%	1%	0.48%	0.40%	0.32%

Cost of Revenues	**(18,044)**	**(71,674)**	**(229,548)**	**(363,435)**	**(567,106)**	**(1,117,326)**	**(1,955,887)**	**(3,637,114)**
	2001	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**
	RMB'000	**RMB'000**	**RMB'000**	**RMB'000**	**RMB'000**	**RMB'000**	**RMB'000**	**RMB'000**
Mobile and telecommuncation value-added services	(10,801)	(49,856)	(141,916)	(232,742)	(360,750)	(660,173)	(1,089,286)	(1,982,501)
Internet value-added services	(4,223)	(14,856)	(75,489)	(116,253)	(188,330)	(423,742)	(796,636)	(1,513,608)
Online advertising	(3,020)	(6,970)	(10,499)	(12,599)	(16,000)	(31,041)	(67,359)	(138,086)
Others	-	-	(1,644)	(1,841)	(2,025)	(2,370)	(2,607)	(2,920)
Percentage Contribution of Total Costs	5%	22%	62%	64%	64%	59%	56%	55%
	2%	6%	33%	32%	33%	38%	41%	42%
	1%	3%	5%	3%	3%	2.78%	3.44%	3.80%
	0%	0%	1%	0.51%	0.36%	0.21%	0.13%	0.08%

Exhibit 6: Discounted Cash Flow - Forecasted Expenditures of Tencent Holdings Limited for the 2004 to 2008 Financial Period

	2001	2002	2003	2004	2005	2006	2007	2008
Depreciation, Amortization & Impairment	(2,448)	(6,155)	(17,188)	(24,259)	(39,271)	(276,128)	(218,141)	(192,462)
As a Percentage of CAPEX (%)	**21%**	**22%**	**29%**	**34%**	**32%**	**45%**	**79%**	**81%**

	2001 RMB'000	2002 RMB'000	2003 RMB'000	2004 RMB'000	2005 RMB'000	2006 RMB'000	2007 RMB'000	2008 RMB'000
Selling & Marketing Expenses	(4,312)	(19,437)	(55,967)	(68,839)	(86,738)	(145,719)	(269,581)	(539,161)
Year-on-Year Growth %		**351%**	**188%**	**23%**	**26%**	**68%**	**85%**	**100%**

	2001 RMB'000	2002 RMB'000	2003 RMB'000	2004 RMB'000	2005 RMB'000	2006 RMB'000	2007 RMB'000	2008 RMB'000
General and Administrative Expenses	(16,297)	(28,860)	(112,011)	(143,374)	(169,181)	(247,005)	(276,645)	(298,777)
Year-on-Year Growth %		**77%**	**288%**	**28%**	**18%**	**46%**	**12%**	**8%**

	2001 RMB'000	2002 RMB'000	2003 RMB'000	2004 RMB'000	2005 RMB'000	2006 RMB'000	2007 RMB'000	2008 RMB'000
Other Operating (Expenses)/Incomes	(82)	(242)	(1,226)	(3,457)	(10,545)	(24,253)	(65,483)	(95,606)
Year-on-Year Growth %		**195%**	**407%**	**182%**	**205%**	**130%**	**170%**	**46%**

Net Finance Costs	**(125)**	**(242)**	**(1,226)**	**2,708**	**2,915**	**3,182**	**3,792**	**4,600**
	2001 RMB'000	**2002 RMB'000**	**2003 RMB'000**	**2004 RMB'000**	**2005 RMB'000**	**2006 RMB'000**	**2007 RMB'000**	**2008 RMB'000**
Interest Income	395	936	2,572	2,881	3,284	3,809	4,495	5,394
Interest Expenses	(617)	-	-	-	-	-	-	-
Bank Charges	(16)	(34)	(154)	(172)	(369)	(627)	(703)	(794)
Percentage Contribution of Total Revenue	77%	76%	64%	106%	113%	-	-	-
	2%	16%	31%	-	-	-	-	-
	16%	7%	4%	-	-	-	-	-
	5%	2%	1%	6.37%	12.66%	19.72%	18.53%	17.26%

Exhibit 7: Discounted Cash Flow - Forecasted Changes in Net Working Capital of Tencent Holdings Limited for the 2004 to 2008 Financial Period

	2001	2002	2003	2004	2005	2006	2007	2008
Current Assets	8,869	62,039	135,598	146,791	203,498	351,301	643,715	1,215,535
Current Liabilities	(8,299)	(11,159)	(102,771)	(141,584)	(193,779)	(226,905)	(334,150)	(495,054)
Working Capital	570	50,880	32,827	5,206	9,720	124,396	309,565	720,481
Net Change in Working Capital	**-**	**50,310**	**(18,053)**	**(27,621)**	**4,513**	**114,676**	**185,170**	**410,916**

	2001	2002	2003	2004	2005	2006	2007	2008
Mobile & Telecommuncation Value-Added Service Revenues	37,960	198,818	467,369	630,948	883,327	1,254,325	2,006,920	3,532,179
Accounts Receivable	8,500	59,094	99,726	139,616	195,463	342,060	632,811	1,202,342
% of Mobile & Telecommuncations Value-Added Service Revenues	**22%**	**30%**	**21%**	**22%**	**22%**	**27%**	**32%**	**34%**

	2001	2002	2003	2004	2005	2006	2007	2008
Total Revenues	49,076	263,107	734,957	999,686	1,413,678	2,068,200	3,441,753	6,306,104
Accounts Receivable	8,500	59,094	99,726	139,616	195,463	342,060	632,811	1,202,342
% of Total Revenues	**17%**	**22%**	**14%**	**14%**	**14%**	**17%**	**18%**	**19%**

	2001	2002	2003	2004	2005	2006	2007	2008
Prepayments, Deposits and Other Receivables	369	2,945	35,872	7,174	8,035	9,241	10,904	13,194
Year-on-Year Growth %	-	**698%**	**1118%**	**-80%**	**12%**	**15%**	**18%**	**21%**

	2001	2002	2003	2004	2005	2006	2007	2008
Other Payables and Accruals	5,273	3,615	59,301	68,196	81,835	102,294	132,982	179,526
Year-on-Year Growth %	**-**	**-31%**	**1540%**	**15%**	**20%**	**25%**	**30%**	**35%**

	2001	2002	2003	2004	2005	2006	2007	2008
Deferred Revenue	-	523	3,676	11,837	22,490	42,281	61,730	76,545
Year-on-Year Growth %	**-**	**-**	**603%**	**222%**	**90%**	**88%**	**46%**	**24%**

	2001	2002	2003	2004	2005	2006	2007	2008
Income Tax Payable	-	-	7,115	20,049	27,615	25,439	41,584	82,418
Year-on-Year Growth %	**-**	**-**	**-**	**182%**	**38%**	**-8%**	**63%**	**98%**

	2001	2002	2003	2004	2005	2006	2007	2008
Other Taxes Payable	3,026	7,021	32,679	41,502	61,838	56,891	97,853	156,565
Year-on-Year Growth %	**-**	**132%**	**365%**	**27%**	**49%**	**-8%**	**72%**	**60%**

Exhibit 8: Discounted Cash Flow - Working Capital Assumptions

In assessing and forecasting the expected changes in Tencent's net working capital the following factors have been considered:

Accounts Receivable

Tencent's trade debtors are expected to increasingly grow over the 2004 to 2008 financial period. In light of Tencent's expansionary measures and revenue forecasts (see Section 6.3.3), this is expected to lead to further delays in the transfer of revenues from mobile and telecommunication operators to Tencent.

This is especially pertinent surrounding the 2006, 2007 and 2008 years upon the release of additional VoIP and PHS value-added services. As such, Tencent's accounts receivable will grow significantly in these years.

Other Payables and Accruals

These include staff costs and welfare accruals, prepayments received from customers and professional fee accruals.

These costs are likely to collective increase with the growth in company revenues as outlined in Section 6.3.3.1, 6.3.3.2, 6.3.3.3, 6.3.3.4.

1. Prepayments, Deposits and Other Receivables[135]

These include VAT refunds receivable, rental deposits, travelling advances to employees, interest receivable, rental prepayments and other payments.

Considering Tencent's growth prospects, these are expected to follow the same growth trend in the 2004 to 2008 financial period

[135] This list is non-exhaustive.

1.1 VAT Refund Receivable

Tencent's VAT refund is more than likely a once-off, non-recurring company event of Tencent Technology (see Appendix A, Exhibit 6). This transaction involved Tencent Technology selling three sets of its self-generated computer software to Tencent Computer in 2003. This was a strategic move by the company to transfer surplus cash from Tencent Computer to Tencent Technology, so that Tencent Technology could meet its working capital requirements.

VAT was levied in accordance with PRC Government standards at 17%.

Accounting for VAT at 17%, the total amount of VAT owed translated into an amount in excess of 3% of the total sales consideration. As Tencent Technology developed and sold the software in its personal capacity, these factors entitled the company to a tax rebate in the form of a government grant. This was in accordance with Chinese Tax legislation, 'Caishui [2000] Document No 25'.

Based on this sequence of events it is assumed that this is a non-recurring, once-off event. Thus it has not been factored into the forecast model.

Deferred Revenues

This represents the sale of prepaid Tencent point cards that are used to purchase IVAS services.

It is expected that these will increase in alignment with forecasted company growth. In effect, this will increase Tencent's portion of current liabilities in future years of operation.

Income Taxes Payable & Other Taxes Payable

With an increase in expected company growth, Tencent's overall taxes will increase over the 2004 to 2008 period.

Exhibit 9: Discounted Cash Flow Calculation of Tencent Holdings Limited on 16 June 2004 for the Forecasted 2004 to 2008 Financial Period

Tencent Holdings Limited Discounted Cash Flow (DCF) Calculation - Unlevered FCFF Approach								
	2003 RMB'000	2004 RMB'000	2005 RMB'000	2006 RMB'000	2007 RMB'000	2008 RMB'000	Terminal Growth Rate	2009 - 200X RMB'000
Net Operating Profit After Tax (NOPAT)	322,196	378,166	520,873	479,825	784,359	1,554,557		
+ Depreciation, Amortization & Impairment	17,188	24,259	39,271	276,128	218,141	192,462		
+ Interest (After Tax @ 2.29%)	0	0	0	0	0	0		
- Capex	(85,469)	(142,878)	(323,000)	(889,999)	(408,791)	(330,472)		
- / + Δ NWC	(18,053)	(27,621)	4,513	114,676	185,170	410,916		
Free Cash Flow	235,862	231,926	241,657	(19,370)	778,879	1,827,463		
Terminal Value							**3.3%**	1,887,769.23
Total Cash Flows		231,926	241,657	(19,370)	778,879	1,827,463		
DCF @ 7.57%		**215,604.70**	**208,841.17**	**-15,561.85**	**581,706.03**	**1,268,792.25**		**30,693,879.01**

Total Firm Value (Enterprise Value)	32,953,261.30
- Long-term Debt	0
+ Cash and Cash Equivalents	325,586
+ Deposit in Connection with the formation of Shiji Kaixuan Technology	11,000
+ Amounts due from Shareholders	82
+ Term Deposits with Initial Term Over 3 Months	23,311
Value of Equity	33,313,240
÷ # Shares	1,680,641
Share Price (RMB)	19.82
Share Price (HK$)	**18.68**
Actual Closing Price - 16 June 2004	
Share Price (RMB)	4.40
Share Price (HK$)	4.15

Appendix E: Tencent's Post-IPO Share Price Performance

Exhibit 1: Tencent's Share Price Performance over the One-Year Period 16 June 2004 to 30 June 2005 [136]

Share Price Performance of Tencent Holdings (HKEx: 700) Over the One-Year Period Dating 16 June 2004 to 30 June 2005						(HK$)
Date	Open	High	Low	Close	Volume	Adj Close
6/16/2004	4.38	4.63	4.07	4.15	2,198,875,000	0.76
6/17/2004	4.15	4.38	4.12	4.23	419,007,500	0.77
6/18/2004	4.2	4.25	3.95	4.03	182,990,000	0.73
6/21/2004	4.1	4.12	3.95	4	114,085,000	0.73
6/23/2004	4.05	4.45	4.03	4.42	275,080,000	0.81
6/24/2004	4.47	4.52	4.33	4.45	173,615,000	0.81
6/25/2004	4.47	4.55	4.35	4.4	106,062,500	0.8
6/28/2004	4.4	4.4	4.25	4.33	73,730,000	0.79
6/29/2004	4.3	4.42	4.3	4.33	75,407,500	0.79
6/30/2004	4.38	4.42	4.3	4.3	61,085,000	0.78
7/2/2004	4.28	4.38	4.17	4.35	65,130,000	0.79
7/6/2004	4.38	4.45	4.35	4.4	77,145,000	0.8
7/7/2004	4.38	4.38	4.25	4.28	65,675,000	0.78
7/8/2004	4.25	4.25	4.07	4.1	105,745,000	0.75
7/9/2004	4.1	4.12	4.03	4.07	46,880,000	0.74
7/12/2004	4.07	4.12	3.98	4	59,850,000	0.73
7/13/2004	4	4.05	3.98	4.03	54,670,000	0.73
7/14/2004	4.03	4.03	3.75	3.8	98,190,000	0.69
7/15/2004	3.82	3.82	3.55	3.68	56,595,000	0.67
7/16/2004	3.65	3.75	3.63	3.7	20,632,500	0.67
7/19/2004	3.7	3.77	3.6	3.77	26,605,000	0.69
7/20/2004	3.73	3.77	3.7	3.75	17,180,000	0.68
7/21/2004	3.8	3.87	3.75	3.77	52,475,000	0.69
7/22/2004	3.75	3.75	3.5	3.55	69,155,000	0.65
7/23/2004	3.55	3.57	3.5	3.52	23,340,000	0.64
7/26/2004	3.45	3.5	3.38	3.4	37,195,000	0.62
7/27/2004	3.38	3.73	3.38	3.73	89,530,000	0.68
7/28/2004	3.73	3.75	3.63	3.68	21,025,000	0.67
7/29/2004	3.63	3.77	3.6	3.75	17,490,000	0.68
7/30/2004	3.8	3.87	3.73	3.85	50,325,000	0.7
8/2/2004	3.85	3.87	3.7	3.87	26,760,000	0.71
8/3/2004	3.9	3.98	3.87	3.95	63,695,000	0.72
8/4/2004	3.9	3.93	3.82	3.85	14,245,000	0.7
8/5/2004	3.9	4.03	3.9	3.98	33,925,000	0.73
8/6/2004	3.93	4.05	3.93	4	21,670,000	0.73
8/9/2004	4	4	3.95	4	22,485,000	0.73
8/10/2004	4.05	4.05	3.87	3.87	21,045,000	0.71
8/11/2004	3.93	3.93	3.68	3.68	32,825,000	0.67
8/12/2004	3.68	3.75	3.63	3.75	25,865,000	0.68
8/13/2004	3.68	3.75	3.68	3.75	4,885,000	0.68
8/16/2004	3.7	3.77	3.6	3.75	13,325,000	0.68
8/17/2004	3.75	3.75	3.68	3.7	4,467,500	0.67

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Yahoo Finance. 2014. Tencent Holdings Ltd. (0700.HK) – Historical Prices.Available: http://finance.yahoo.com/q/hp?s=0700.HK&a=05&b=16&c=2004&d=07&e=27&f=2014&g=d&z=66&y=2508 [2014, August 27].

Share Price Performance of Tencent Holdings (HKEx: 700) Over the One-Year Period Dating 16 June 2004 to 30 June 2005						(HK$)
Date	**Open**	**High**	**Low**	**Close**	**Volume**	**Adj Close**
10/19/2004	4.6	4.68	4.47	4.58	10,985,000	0.83
10/20/2004	4.55	4.58	4.33	4.38	18,675,000	0.8
10/21/2004	4.38	4.38	4.28	4.3	22,575,000	0.78
10/25/2004	4.3	4.3	4.17	4.17	19,560,000	0.76
10/26/2004	4.15	4.2	4.12	4.17	20,075,000	0.76
10/27/2004	4.33	4.47	4.33	4.45	48,090,000	0.81
10/28/2004	4.52	4.8	4.52	4.65	108,195,000	0.85
10/29/2004	4.55	4.68	4.52	4.6	22,935,000	0.84
11/1/2004	4.55	4.6	4.52	4.6	4,610,000	0.84
11/2/2004	4.6	4.8	4.58	4.77	37,255,000	0.87
11/3/2004	4.7	4.75	4.63	4.7	21,795,000	0.86
11/4/2004	4.7	4.7	4.42	4.42	34,965,000	0.81
11/5/2004	4.52	4.58	4.45	4.5	22,260,000	0.82
11/8/2004	4.5	4.52	4.45	4.5	12,465,000	0.82
11/9/2004	4.55	4.65	4.52	4.55	24,255,000	0.83
11/10/2004	4.63	4.63	4.55	4.58	10,645,000	0.83
11/11/2004	4.58	4.58	4.5	4.5	11,540,000	0.82
11/12/2004	4.63	4.68	4.55	4.63	32,650,000	0.84
11/15/2004	4.63	4.77	4.63	4.65	59,820,000	0.85
11/16/2004	4.63	4.68	4.58	4.68	31,800,000	0.85
11/17/2004	4.65	5.15	4.65	5.05	143,400,000	0.92
11/18/2004	5.05	5.25	4.68	4.68	157,915,000	0.85
11/19/2004	4.7	4.93	4.68	4.93	63,425,000	0.9
11/22/2004	4.93	5.25	4.88	5.1	60,730,000	0.93
11/23/2004	5.1	5.5	5.1	5.4	48,910,000	0.98
11/24/2004	5.45	5.45	5.15	5.25	31,350,000	0.96
11/25/2004	5.2	5.35	5.1	5.25	29,065,000	0.96
11/26/2004	5.15	5.55	5.15	5.45	49,240,000	0.99
11/29/2004	5.5	5.95	5.5	5.8	58,280,000	1.06
11/30/2004	5.75	6.05	5.75	5.9	20,400,000	1.08
12/1/2004	5.9	5.9	5.7	5.75	22,470,000	1.05
12/2/2004	5.95	6.1	5.85	6.05	36,315,000	1.1
12/3/2004	6.15	6.35	5.85	5.85	28,845,000	1.07
12/6/2004	5.9	6	5.85	5.9	4,615,000	1.08
12/7/2004	5.9	5.9	5.45	5.55	52,670,000	1.01
12/8/2004	5.55	5.55	5.4	5.4	22,775,000	0.98
12/9/2004	5.5	5.55	5.4	5.45	19,700,000	0.99
12/10/2004	5.5	5.75	5.45	5.55	23,960,000	1.01
12/13/2004	5.7	5.75	5.6	5.7	15,830,000	1.04
12/14/2004	5.7	5.7	5.5	5.55	52,860,000	1.01
12/15/2004	5.55	5.8	5.55	5.75	40,060,000	1.05
12/16/2004	5.85	5.85	5.65	5.7	6,275,000	1.04

Share Price Performance of Tencent Holdings (HKEx: 700) Over the One-Year Period Dating 16 June 2004 to 30 June 2005						(HK$)
Date	**Open**	**High**	**Low**	**Close**	**Volume**	**Adj Close**
12/17/2004	5.7	5.7	5.55	5.55	8,705,000	1.01
12/20/2004	5.55	5.6	5.25	5.3	40,420,000	0.97
12/21/2004	5.4	5.65	5.4	5.55	42,825,000	1.01
12/22/2004	5.55	5.6	5.05	5.1	85,435,000	0.93
12/23/2004	5	5	4.68	4.85	128,610,000	0.88
12/24/2004	4.85	4.98	4.85	4.98	20,875,000	0.91
12/28/2004	4.98	4.98	4.77	4.88	32,205,000	0.89
12/29/2004	4.88	4.88	4.63	4.75	41,795,000	0.87
12/30/2004	4.72	4.75	4.63	4.65	35,200,000	0.85
12/31/2004	4.65	4.72	4.63	4.63	38,835,000	0.84
1/3/2005	4.7	4.75	4.63	4.63	42,585,000	0.84
1/4/2005	4.68	4.8	4.65	4.8	82,450,000	0.88
1/5/2005	4.75	4.75	4.65	4.7	48,495,000	0.86
1/6/2005	4.7	4.72	4.65	4.7	41,089,000	0.86
1/7/2005	4.7	4.75	4.65	4.7	37,435,000	0.86
1/10/2005	4.75	4.98	4.75	4.82	36,060,000	0.88
1/11/2005	4.9	4.9	4.72	4.75	41,505,000	0.87
1/12/2005	4.8	4.8	4.72	4.75	24,300,000	0.87
1/13/2005	4.75	4.77	4.63	4.68	20,535,000	0.85
1/14/2005	4.65	4.8	4.65	4.75	29,595,000	0.87
1/17/2005	4.75	4.75	4.7	4.75	18,455,000	0.87
1/18/2005	4.77	4.77	4.65	4.7	19,800,000	0.86
1/19/2005	4.72	4.77	4.58	4.68	16,615,000	0.85
1/20/2005	4.6	4.6	4.42	4.52	40,875,000	0.83
1/21/2005	4.5	4.5	4.28	4.33	31,335,000	0.79
1/24/2005	4.3	4.45	4.28	4.45	39,025,000	0.81
1/25/2005	4.45	4.5	4.3	4.5	22,405,000	0.82
1/26/2005	4.58	4.58	4.4	4.42	13,940,000	0.81
1/27/2005	4.47	4.52	4.45	4.45	23,495,000	0.81
1/28/2005	4.45	4.52	4.42	4.52	24,525,000	0.83
1/31/2005	4.5	4.55	4.45	4.55	17,615,000	0.83
2/1/2005	4.55	4.7	4.55	4.68	24,934,000	0.85
2/2/2005	4.75	4.85	4.7	4.85	53,495,000	0.88
2/3/2005	4.82	4.93	4.75	4.8	11,154,000	0.88
2/4/2005	4.8	5.2	4.8	5	77,120,000	0.91
2/7/2005	5.1	5.1	4.95	4.95	17,265,000	0.9
2/8/2005	4.95	4.98	4.75	4.82	29,890,000	0.88
2/14/2005	4.88	5	4.85	5	33,305,000	0.91
2/15/2005	5	5	4.82	4.9	21,540,000	0.89
2/16/2005	4.93	4.95	4.8	4.85	9,360,700	0.88
2/17/2005	4.9	4.98	4.85	4.9	11,493,500	0.89
2/18/2005	4.9	4.93	4.85	4.93	5,665,000	0.9

Share Price Performance of Tencent Holdings (HKEx: 700) Over the One-Year Period Dating 16 June 2004 to 30 June 2005						(HK$)
Date	**Open**	**High**	**Low**	**Close**	**Volume**	**Adj Close**
2/21/2005	4.95	5.4	4.95	5.35	208,600,000	0.98
2/22/2005	5.35	5.35	5.2	5.25	28,412,000	0.96
2/23/2005	5.3	5.3	5.05	5.2	47,290,000	0.95
2/24/2005	5.3	5.3	5.15	5.15	13,200,000	0.94
2/25/2005	5.25	5.3	5.2	5.3	14,110,000	0.97
2/28/2005	5.3	5.35	4.98	5.1	26,890,000	0.93
3/1/2005	5.15	5.15	5.05	5.15	5,000,000	0.94
3/2/2005	5.15	5.15	5.05	5.05	5,941,500	0.92
3/3/2005	5.05	5.1	5	5.1	9,486,500	0.93
3/4/2005	5.15	5.35	5.15	5.2	26,275,000	0.95
3/7/2005	5.3	5.35	5.25	5.3	20,345,000	0.97
3/8/2005	5.3	5.45	5.3	5.3	19,895,000	0.97
3/9/2005	5.3	5.3	5.2	5.2	7,490,000	0.95
3/10/2005	5.2	5.4	5.15	5.35	19,775,000	0.98
3/11/2005	5.3	5.3	5.15	5.3	14,820,000	0.97
3/14/2005	5.2	5.25	5.2	5.2	5,380,000	0.95
3/15/2005	5.2	5.2	5.05	5.1	12,380,000	0.93
3/16/2005	5.05	5.15	4.98	5.05	12,450,000	0.92
3/17/2005	5	5.2	4.98	5.15	31,675,000	0.94
3/18/2005	5.2	5.3	5.1	5.25	24,460,000	0.96
3/21/2005	5.3	5.7	5.15	5.55	80,050,000	1.01
3/22/2005	5.5	5.55	5.4	5.5	19,405,000	1
3/23/2005	5.4	5.6	5.4	5.55	24,195,000	1.01
3/24/2005	5.55	5.95	5.55	5.8	73,505,000	1.06
3/29/2005	5.75	5.85	5.75	5.8	28,100,000	1.06
3/30/2005	5.7	5.8	5.65	5.75	25,398,500	1.05
3/31/2005	5.75	5.8	5.65	5.65	28,167,500	1.03
4/1/2005	5.7	5.7	5.45	5.65	12,650,000	1.03
4/4/2005	5.65	5.65	5.45	5.5	17,835,000	1
4/6/2005	5.5	5.55	5.45	5.55	14,110,000	1.01
4/7/2005	5.6	5.6	5.5	5.55	18,300,000	1.01
4/8/2005	5.6	5.6	5.5	5.5	13,320,000	1
4/11/2005	5.55	5.55	5.4	5.45	9,470,000	0.99
4/12/2005	5.5	5.6	5.5	5.55	14,560,000	1.01
4/13/2005	5.55	5.55	5.4	5.5	4,066,700	1
4/14/2005	5.45	5.45	5.3	5.4	14,250,000	0.98
4/15/2005	5.3	5.3	5.15	5.2	12,130,000	0.95
4/18/2005	5.1	5.15	5.05	5.05	22,460,000	0.92
4/19/2005	5.05	5.15	5	5.1	24,904,500	0.93
4/20/2005	5.15	5.2	5.1	5.1	10,915,000	0.93
4/21/2005	5.1	5.1	5.05	5.1	10,390,000	0.93
4/22/2005	5.2	5.35	5.2	5.35	22,020,000	0.98

Share Price Performance of Tencent Holdings (HKEx: 700) Over the One-Year Period Dating 16 June 2004 to 30 June 2005						(HK$)
Date	**Open**	**High**	**Low**	**Close**	**Volume**	**Adj Close**
4/25/2005	5.3	5.3	5.2	5.25	13,990,000	0.96
4/26/2005	5.3	5.4	5.2	5.35	19,595,000	0.98
4/27/2005	5.35	5.5	5.3	5.45	46,517,900	0.99
4/28/2005	5.5	5.6	5.5	5.6	11,073,000	1.02
4/29/2005	5.6	5.6	5.3	5.4	14,835,000	0.98
5/3/2005	5.4	5.55	5.4	5.5	17,340,000	1
5/4/2005	5.5	5.5	5.45	5.5	3,105,000	1
5/5/2005	5.5	5.7	5.5	5.65	18,455,000	1.03
5/6/2005	5.65	5.7	5.55	5.6	9,470,000	1.02
5/9/2005	5.6	5.65	5.5	5.6	13,220,000	1.02
5/10/2005	5.7	5.7	5.6	5.65	20,260,000	1.03
5/11/2005	5.6	5.6	5.45	5.45	14,030,000	0.99
5/12/2005	5.5	5.55	5.4	5.5	9,090,000	1
5/13/2005	5.5	5.5	5.25	5.25	20,340,000	0.96
5/17/2005	5.3	5.35	5.2	5.35	4,460,000	0.98
5/18/2005	5.35	5.4	5.2	5.3	10,905,000	0.97
5/19/2005	5.25	5.65	5.2	5.6	54,335,000	1.02
5/20/2005	5.6	5.65	5.5	5.5	16,980,000	1
5/23/2005	5.5	5.5	5.4	5.5	11,182,000	1
5/24/2005	5.5	5.5	5.4	5.45	11,370,000	0.99
5/25/2005	5.5	5.55	5.4	5.45	22,150,000	0.99
5/26/2005	5.45	5.6	5.35	5.55	22,060,000	1.01
5/27/2005	5.6	5.65	5.45	5.6	37,780,000	1.02
5/30/2005	5.6	5.6	5.5	5.5	13,570,000	1
5/31/2005	5.55	5.55	5.5	5.55	73,255,000	1.01
6/1/2005	5.55	5.6	5.55	5.55	21,665,000	1.01
6/2/2005	5.6	5.9	5.6	5.8	98,985,000	1.06
6/3/2005	5.85	6	5.65	5.65	29,927,500	1.03
6/6/2005	5.7	5.85	5.7	5.75	29,265,000	1.05
6/7/2005	5.8	5.85	5.75	5.8	12,145,000	1.06
6/8/2005	5.8	6	5.8	5.95	49,503,100	1.09
6/9/2005	5.95	6	5.85	5.95	13,635,000	1.09
6/10/2005	5.95	6.05	5.85	5.85	10,516,000	1.07
6/13/2005	5.9	5.95	5.8	5.9	9,447,500	1.08
6/14/2005	5.9	6.1	5.9	6	30,285,400	1.09
6/15/2005	6	6.05	5.95	6	4,640,000	1.09
6/16/2005	6	6	5.75	5.95	8,940,000	1.09
6/17/2005	5.9	6.3	5.9	6.25	41,840,000	1.14
6/20/2005	6.2	6.25	6.15	6.25	22,705,000	1.14
6/21/2005	6.2	6.2	6.15	6.15	8,035,000	1.12
6/22/2005	6.2	6.5	6.15	6.4	24,765,000	1.17
6/23/2005	6.4	6.65	6.4	6.45	46,162,200	1.18

Share Price Performance of Tencent Holdings (HKEx: 700) Over the One-Year Period Dating 16 June 2004 to 30 June 2005						(HK$)
Date	**Open**	**High**	**Low**	**Close**	**Volume**	**Adj Close**
6/24/2005	6.5	6.5	6.35	6.45	52,702,400	1.18
6/27/2005	6.4	6.45	6.35	6.4	18,065,000	1.17
6/28/2005	6.3	6.3	6.05	6.1	52,325,000	1.11
6/29/2005	6.2	6.2	6.15	6.15	9,460,000	1.12
6/30/2005	6.15	6.2	5.85	5.9	31,645,000	1.08

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