

**[TME] - Tencent Music Entertainment Group
First Quarter 2019 Earnings Conference Call
Monday, May 13, 2019, 8:00 PM Eastern**

Officers

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Tony Yip, CSO
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Presentation

Operator: Ladies and gentlemen, good evening and good morning, and thank you for standing by. Welcome to the Tencent Music Entertainment Group First Quarter 2019 Earnings Conference Call. At this time, all participants are in listen-only mode. (Operator Instructions).

Today you will hear discussions from the management team of Tencent Music Entertainment Group, followed by a question-and-answer session. Please be advised that this conference is being recorded today.

Now I will turn the conference over to your speaker host today, Ms. Millicent Tu. Please go ahead, ma'am.

Millicent Tu: Thank you, operator. Hello, everyone, and thank you all for joining us on today's call. Tencent Music has announced its quarterly financial results today after the market close. An earnings release is now available on our IR website at ir.tencentmusic.com, as well as on the newswire services.

Today, you will hear from Mr. Cussion Pang, our CEO, who will start the call with an overview of our recent achievements and our growth strategies. He will be followed by Mr. Tony Yip, our CSO, who will offer more details on our business developments.

Lastly, Ms. Shirley Hu, our CFO, will address our financial results before we open the call for questions.

Before we proceed, please note that this call may contain forward-looking statements made pursuant to the safe harbor provisions for the Private Securities Litigation Reform Act of 1995. These forward-looking statements are based on management's current expectations and observations that involve known and unknown risks, uncertainties, and other factors not under the Company's control which may cause actual results, performance, or achievements of the Company to be materially different from the results, performance, or expectations implied by these forward-looking statements.

All forward-looking statements are expressly qualified in their entirety by the cautionary statements, risk factors, and details of the Company's filings with the SEC. The Company does not assume any obligation to revise or update any forward-looking statements as a result of new information, future events, changes in market conditions, or otherwise except as required by law.

Please also note that the Company will discuss non-IFRS measures today, which are more thoroughly explained and reconciled to the most comparable measures reported under the International Financial Reporting Standard in the Company's earnings release and filings with the SEC. You're reminded that such non-IFRS measures should not be viewed in isolation, or as an alternative to the equivalent IFRS measure, and that non-IFRS measures are not uniformly defined by all companies including those in the same industry.

With that, I am now very pleased to turn over the call to Mr. Cussion Pang, CEO of Tencent Music. Cussion?

Cussion Pang: Thank you, Millicent. Hello, everyone. Thank you all for joining our call today.

We started year of 2019 with solid first quarter results. Our revenue grew by 39% year-on-year, driven by healthy growth on both our online music and social entertainment services. Most notably, paying users for both online music and social entertainment services increased by double-digit percentages year-on-year during the first quarter of 2019.

Paying users for our online music services and paying user retention rate grew steadily as we continued to solidify our content leadership, improve product features, and enhance our data technology.

To further diversify our content, we forged additional partnerships with industry-leading music labels, engaged in closer collaboration with other labels to promote original soundtrack music, continued discovering emerging musicians, and added more video and long-form audio formats to our music content offering.

Meanwhile, as the largest online music platform in China, we made further progress in leveraging our all-encompassing distribution capabilities and enhancing our playlists to

engage users and improve user stickiness. In addition, we drove user interactions and improved user loyalty by utilizing data analytics and other proprietary technologies to introduce more personalization features and special audio settings.

As wireless data network coverage improves and the cost of mobile data usage decreases in China, our users are increasingly consuming music content through streaming services, implying a gradual decline in downloading music content. To capitalize on such changes in our user behavior, we began adopting the pay-for-stream model and educating users in turn.

We are encouraged by early results and confident that our transition towards a pay-for-streaming model will gradually gain traction in the future. Such materialization will sustain our long-term growth for years to come, and ultimately create exciting opportunities for the industry.

In our social entertainment services, MAUs reached 225 million despite quarter-over-quarter fluctuations. Such a scale speaks volumes of our market leadership. While encouraging the user experiences of our core users, we will step up our WeChat Mini Program initiatives and additional lite versions of our apps to reach and attract a broader group of users. By relentlessly sharpening our focus on product innovation and enhancing our user experience, we will further strengthen our ability to engage, grow and maintain our large user base.

We also continued to introduce more innovative product features for our social entertainment services. To give you one example, our newly introduced feature, titled "Grab the Mic" produced meaningful improvements in operating metrics such as user retention rate in the first quarter of 2019. We are confident that our successful track record, as well as our outstanding capabilities in R&D and innovation, will enable us to continue expanding our market share in the music-centric social entertainment industry going forward.

In summary, we achieved strong financial performance and expanded our user community in the first quarter of 2019. We believe our investments in content, product innovation, and technology will continuously enhance user stickiness. Furthermore, they will solidify our platform as an all-in-one music entertainment destination where users can seamlessly engage with music in a highly social setting.

Now I will turn the call over to Tony to discuss the development of our business in more detail.

Tony Yip: Thank you, Cussion. During the first quarter of 2019, both our online music and social entertainment services grew healthily.

In online music services, we grew paying users by 27% year-on to 28.4 million. This was accomplished by our continued focus in three areas: content diversity, strengthening promotional capabilities, and technology advancements.

First, we continued to implement a multi-pronged strategy to enrich content. We have further strengthened our collaboration with upstream partners. In January, we established a partnership with SM Entertainment, a premier music label in Asia boasting one of the largest song repositories in South Korea.

During the first quarter, we also successfully released and promoted songs through Liquid State, a music joint venture label specializing in electronic dance music that we jointly launched with Sony Music in 2018. In this partnership, we have utilized our industry-leading distribution and promotional capabilities to popularize new songs successfully. For example, the top-selling song in Chinese called ["Su"] was played several hundred million times in the first quarter.

In addition, we continue to broaden unique content in our library. During the first quarter, we successfully obtained the master license to the original music soundtrack of a very popular TV drama titled "The Story of Minglan." One of the main theme songs was played approximately 1 billion times in the first quarter.

Our content diversification strategy has yielded good results. As of March 2019, the total number of songs available on our platform increased to over 35 million.

Beyond the number of songs, we also added more music-related videos, talk shows and audiobooks to our content offering. As we increased the number of long-form content on our platform, the average play time for such content grew substantially. For example, our "Idol Reads" series, featuring book readings by role model artists and top celebrities, recorded a double-digit percentage increase in total playing time for its second season compared to its first season.

During the quarter, we introduced the first season of "This is Original," an innovative music variety show that discovers new music talents. We also co-invested in this music variety show together with the producer of The Voice of China. It attracted a large number of contestants to our platform and encouraged them to produce their own cover versions of the songs featured in the show. We then utilized celebrity endorsements and other social media resources from our platform to help the show become a viral sensation, which has further demonstrated the content development, distribution, and promotion capabilities of our platform.

We also made further progress in expanding our video content by launching new episodes of our self-produced show called "Kuguo Music Zone." During the show, well-known celebrities discussed their music creations and real-life aspirations, successfully reducing the emotional distance between artists and their fans. In addition to viewing their idols, fans could interact with them by competing for viewing seats and sending virtual gifts. As a result, the show's play volume and addition of new users have all doubled in the first quarter of 2019 compared to the fourth quarter of 2018.

Second, we continued to strengthen our promotional capability. By leveraging our strength in fan-based economy, we provide the unique platform for artists to showcase their talents and reach hundreds of millions of music lovers online. We helped several

established artists and emerging artists to promote their digital albums and generate impressive sales figures. For example, one newly released digital album by a popular female singer quickly exceeded RMB5 million in sales within 2 months.

We continue to introduce more proprietary playlists, which categorize songs by genre, time period, themes, mood, and other criteria. We further expanded the number of songs on these playlists, which in turn increased the number of plays and help users discover new music.

Third, we continued to invest in two major technology areas: audio settings and personalization features. To date, we have introduced more than 5,000 special audio settings. For example, our audio setting that mimics virtual surroundings received positive user feedback.

We have used personalization features such as smart tagging, deep learning-based playlist recommendations, and data analytics to increase user time spent on our platform. In fact, within just one year, we have developed some of the most comprehensive tagging expertise in the music industry. Today, our smart tagging technology is capable of categorizing a song by thousands of different criteria. This capability has enabled us to improve the accuracy of our recommendations based on user patterns and preferences.

I would also like to highlight the progress we achieved in certain new technologies. In the first quarter, our music and song recognition feature gained increasing popularity among users, enabling us to better assist users in the music discovery journey. Capable of creating a digital fingerprint for any given song, this feature locates songs in our music database to provide the name, artist, lyrics, and other song information to our users in a matter of seconds.

Lastly, our ringtone feature also continued its rapid ramp-up, as its user base increased by high-double-digits in the percentage in the first quarter sequentially.

Now, let's turn to our social entertainment business. Overall, our social entertainment business recorded healthy growth. Paying users increased by 13% year-on-year to 10.8 million. Mobile MAU remained steady compared to the first quarter of 2018. ARPPU recorded double-digit growth. Our growth was driven by a combination of three areas; first, product enhancement and innovation; second, use of our platform as an effective promotional channel; and third, data-driven personalization.

First, let's look at product enhancement and innovation. During the quarter, we continued to introduce innovative ways to engage users on WeSing, the leading online karaoke platform in China. One new feature called "Grab the Mic" achieved a high user retention rate during the first quarter.

"Grab the Mic" allows users to either invite a group of their friends, or join a song room with strangers, matched with users using our algorithms. Once in a group, users will then hear parts of the same song. They are scored based on the time it takes them to identify the song, as well as the accuracy of their lyrics and vocal keys while singing along. This feature helps encourage user interactions and drive user engagement.

In addition, we further optimized our recommendation engine that leverages data analytics to match users with the singing rooms they are most likely to enjoy. As users perform their favorite songs, they receive virtual gifts from others and increase their scores in our ranking system. This refinement further improved users' song room entry rate.

Furthermore, we developed a feature that allows users to record their own poem readings and add background music from our extensive music library.

Going forward, as Cussion mentioned earlier, we will continue to explore WeChat Mini Program initiatives and deploy additional lite versions of our apps to cater to different user preferences and captivate a broader group of users.

We also utilized more singing contest features to improve interactions between users and live streaming performers. Such features attracted numerous live streaming performers, enabling them to attract more followers compared to those who did not use this feature. Importantly, the majority of these performers had relatively low public recognition levels in the past. By helping these less popular performers to grow, we further diversified our live streaming performer base to foster a more healthy live streaming ecosystem.

We also introduced a new multi-performer live streaming model. This model selects a group of popular performers and allocates 15 minutes of performance time to each. Viewers can access a variety of music-related live streaming content without having to switch between different show rooms. It has been very effective in attracting and converting new users. It has also improved the overall average user time spent significantly.

Second, more emerging talents found success on our platform while contributing a variety of music content. This year, "WeSing Annual Carnival" recorded more success in terms of discovering talent, as well as performer and user participation rate, which were up 49% and 128% year-on-year, respectively.

One of this year's top three contestants leveraged our WeSing platform as a launch pad to showcase his singing talent, reaching millions of audience, and published multiple digital albums. Musicians like him have added high-quality content to our library and thereby attracted more users to our platform, thus forming a virtuous cycle.

Our music-centric live streaming platform enables us to discover and nurture emerging artists too. Another emerging artist, as another example, she was discovered through our live streaming platform and went on to develop her professional singing career. She continued to engage with her fans and publish even more new songs through our platform. This in turn expanded our music library. Such examples truly demonstrate our unique position as an integrated, all-in-one online music entertainment platform which allows our users to discover, listen, sing, watch, perform, and socialize around music.

Third, our personalization content recommendation engine continued to drive better user experience. Our data-driven personalization engine leverages in-depth analysis to recommend different types of music-centric content to users. Recommended content can

include songs, radio, short videos, and live streaming. The result of this personalization has improved the average time spent on the WeSing app sequentially.

In summary, we continued our healthy growth trajectory across all business lines in the first quarter. Looking forward, we believe that our vast content library, immense data repository, and proprietary technology will enable us to attract more users, improve our user experience, and increase our monetization capabilities.

With that, I would like to turn over to our CFO, Shirley Hu, for a closer review of our financials.

Shirley Hu: Thank you, Tony. Hello, everyone.

For the first quarter of 2019, our revenues increased by 39% year-over-year to RMB5.7 billion. The increase was driven by the solid growth in both our online music and social entertainment businesses.

Revenues from online music services increased by 28% year-over-year to RMB1.6 billion. This growth was mainly due to an increase in subscription revenue and the sub-licensing revenue to other companies including third-party music platforms and the Tencent Group. There were also higher digital music album sales in the quarter. Sales of subscription packages contributed RMB710 million in revenue, up from RMB565 million year-over-year.

In Q1, we continued to offer promotional deals for long-term subscribers, including automatic renewal and annual package subscribers. On the other hand, premium membership subscriptions gained more weight in our total subscription base. Thus, there was a slight decrease in our ARPPU from RMB8.4 in Q1 2018 to RMB8.3 in Q1 2019.

We have also seen a steady improvement in subscriber retention rate over the past 5 quarters. The improvement of the subscriber retention rate will continue to be our focus in 2019.

Revenues from social entertainment services increased by 44% year-over-year to RMB4.1 billion, primarily driven by the revenue growth in our online karaoke and live streaming services.

Our ARPPU in social entertainment services increased by 30% to RMB129 year-over-year, while paying user penetration rate also improved from 4.3% to 4.8%.

"WeSing's Annual Carnival" was not only successful in revenue generation and ARPPU expansion during the quarter, but also increased the user participation and provided a stage for artists to improve their performances.

Cost of revenues increased by 52% year-over-year to RMB3.7 billion. The increase was attributable to higher content and revenue-sharing fees. The increase in content fees was mainly attributable to the increased market price and the amount of music content licensed from music labels and other content partners, as well as increased investments in

the production of high-quality original music content. The increase in revenue-sharing fees reflects the growth in our social entertainment services and the higher percentage of revenue contributed from professionally-generated content providers.

Our gross margin was 35.4% in Q1 2019. We are in the process of ramping up our in-house productions, and many of the shows were still in the preparatory stage during Q1.

Now, let's turn to our operating expenses. Our total operating expenses increased by 28% year-over-year to RMB1 billion. Selling and marketing expenses for Q1 2019 were RMB437 million, representing an increase of 20% year-over-year. The increase was primarily due to increased spending on branding and promotion of our content.

General and administrative expenses increased by 35% year-over-year to RMB602 million in Q1 2019. The increase was mainly due to the higher employee benefit expenses as we continued to invest in our workforce. There has been a gradual increase in the size and the pay scale of our personnel in the past quarters.

We have seen improvement in operating leverage on a year-over-year basis. Operating expenses as a percentage of revenues decreased to 18% in Q1 2019 from 20% in Q1 2018.

Our effective tax rate was 12.4% in Q1 2019, compared to 9.2% in Q1 2018. The increase was mainly due to the change in the preferential tax rates of certain subsidiaries.

As a result of the foregoing, our net profit attributable to equity holders of the Company increased by 17% year-over-year to RMB987 million, and our non-IFRS net profit attributable to equity holders of the Company increased by 15% year-over-year to RMB1.2 billion. Our non-IFRS net profit margin was 20.9% in Q1 2019.

As of March 31, 2019, our combined balance of cash and cash equivalents and term deposits amounted to RMB18.1 billion, an increase of RMB748 million compared to RMB17.4 billion as of December 31, 2018. The increase in the balances was primarily due to cash flow generated from operations of RMB926 million.

Our cash and cash equivalents balance was also affected by the change in the exchange rate of RMB to USD at differential balance sheet dates. The exchange rate was 6.7 to 1 on March 29, 2019, and 6.9 to 1 on December 31, 2018.

With our strong profitability and cash flow, we will continue to invest in our products and content offering. These investments will help to expand our user base and improve user engagement, both of which are crucial to our sustainable revenue growth in the long term. We are confident that such efforts will create long-term shareholder value, as well as increase the return on capital for investors.

This concludes our prepared remarks. Operator, we are ready to open the call for questions.