

Chinasoft (354 HK)

China / Software & Services / Company Update

Target price: HK\$4.55
Previous TP: HK\$2.08
Last price: HK\$3.66
Potential Return: 24.3%

Upgrade to BUY

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Dancing with the IT giants

- Strong IT order from Huawei, HSBC and Tencent
- Prime beneficiary of Huawei's increasingly outsource
- Outsourcing platform JointForce to monetize soon
- Above consensus 27% 2 years CAGR in EPS



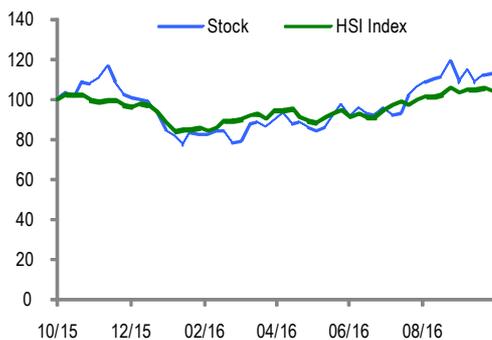
Forecast revision (%)

Year to 31 Dec	16F	17F	18F
Revenue change	N.A.	N.A.	N.A.
Net profit change	N.A.	N.A.	N.A.
EPS change	N.A.	N.A.	N.A.

Key Share Data

Bloomberg code	354 HK
52-week High / Low	HKD\$ 3.97 / 2.45
30D avg volume	18.46 Mn
Issued shares	2,211.90 Mn
Market cap.	8,007 Mn
Major Shareholder (% of total shares)	Chen Yu Hong (12.24%)

Share Price Performance



Key Financials

Year to 31 Dec	2015	2016F	2017F	2018F
Turnover (RMB m)	5,129	6,134	8,046	9,846
Growth (%)	16	20	31	22
*Net Profit (RMB m)	166	418	554	730
Growth (%)	(3)	151	33	32
*EPS (RMB)	0.083	0.193	0.241	0.312
Growth (%)	(9)	131	25	29
PER (x)	36.0	16.5	13.1	10.2
DPS (HK\$)	-	-	-	-
Yield (%)	-	-	-	-

*excludes convertible adjustment and disposal gain

Source: Core Pacific Yamaichi estimates

What's New

We had an update with the Investor Relations of Chinasoft.

Catalysts

Prime beneficiary of Huawei's increasingly outsource. We forecast 27.9%/34.5%/23.5% segmental top line growth of TPG for FY16F to 18F, as mainly driven by increasing IT outsourcing order from Huawei, CSI's largest customer with 50% revenue contribution. Amid growing revenue but rising margin pressure, Huawei will increasingly outsource. With Huawei being a shareholder of 4% stake and solid outsourcing track record, CSI is gaining market share in Huawei outsourcing to 60% and is a prime beneficiary of this trend. We also see strong IT order flow from blue chip clients such as HSBC, Tencent, and Ping An Bank.

Outsourcing platform JointForce to monetize soon. JointForce, the online B2B matching platform for IT freelancers unveiled in late 2014, is entering into harvest period of monetization. We argue CSI made a smart move by leaning on a platform based model to make use of its expertise on IT outsourcing, while maximizing business exposure. Many large enterprises such as Yonyou and Founder are now using JointForce as a platform to outsource. Though we only project RMB100 mn/400 mn revenue in FY16F/17F, we reckon JointForce can give a meaningful boost to bottom line due to its significantly higher profitability.

Our View

Above consensus 27% 2 years CAGR in EPS. We now forecast 151%/33%/32% core net profit growth (excluding convertible adjustment and disposal gain) for FY16F/17F/18F, on the back of 20%/31%/22% top line growth. While our FY16F bottom line is in line with the street, our FY17F/18F figures lie on the high end of consensus as we are more confident on the growth of blue chip clients, room of operating leverage, and higher profitability from JointForce.

Valuation

Growth prospect not fully acknowledged. We argue Chinasoft is poised to reap further dividend from its accumulated knowhow in IT outsourcing and strengthening ties with blue chip clients, while the JointForce platform can be a future bright spot. We upgrade to BUY with target price at HK\$4.55, representing 20.5x/16.3x FY16F/17F PER, and 0.75x FY16F-18F PEG.

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Strong IT order from Huawei, HSBC and Tencent

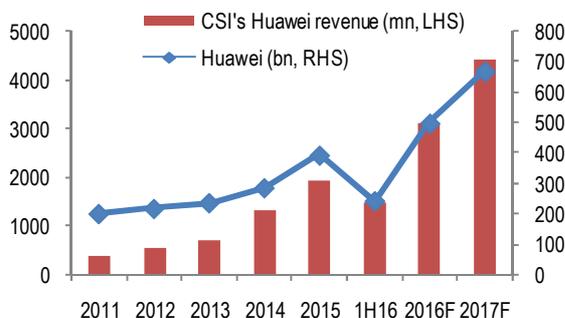
29% 3 years CAGR for TPG. Chinasoft International (CSI) conducts IT solutions and outsourcing for large enterprises through TPG (Technical and Professional services). The segment reported 77%/30% growth in 1H16 operating profit and revenue to RMB250 mn/ 2,288 mn respectively. We forecast 27.9%/34.5%/23.5% segmental top line growth for FY16F to 18F:

Ride on increasing outsourcing from Huawei. Being the largest client of CSI and contributing to 50% of group revenue, Huawei generated RMB1,491 mn revenue in 1H16, up 90% yoy. We forecast 61.5%/40.6%/27.5% revenue growth from Huawei for FY16F to 18F, representing RMB3,150 mn/4,430 mn/5,650 mn and will continue to be the major growth driver:

- i. **Huawei targets 20% growth.** Huawei revenue and CSI's outsourcing revenue from Huawei generally move in the same direction. In 1H16, Huawei revenue rose 40%, while CSI's revenue from Huawei surged 90%. Huawei management eyes USD75 bn revenue in FY16F, up 23% yoy and targets USD150 bn revenue by FY20F, implying 19% 4 years CAGR.
- ii. **Cost pressure motivates Huawei to outsource more.** Huawei is suffering heavy margin pressure because of R&D commitment, in spite of high top line growth. Having peaked in FY13, Huawei operating margin in FY15 shrank 0.3 pts to 11.6%. In 1H16, the margin further lost 6 pts to 12%. We also spot the picking up Huawei outsourcing revenue growth to 88% in FY14 came in coincidence with Huawei's dropping margin in that year. Pundits believe that Huawei will freeze or cut its 170k headcount and it follows naturally that Huawei will increasingly outsource.
- iii. **Huawei being a major shareholder guarantees rising market share.** Given that Huawei acquired 4% equity stake in CSI via share issuance in Oct 2015 (for CSI to acquire full equity interest in the outsourcing joint venture), CSI is gaining market share in Huawei outsourcing to 60%. Mobile payment, financial big data, cloud computing, telecom billing and software are particular application growth drivers. The diverging growth rate between Huawei and CSI outsourcing revenue also supports the claim of increasing market share in Huawei.

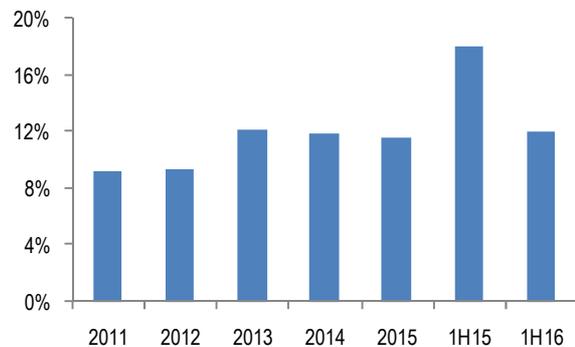
HSBC and Tencent are also drivers. We project 9% 3 years CAGR for non - Huawei TPG revenue as driven by several blue chip accounts: (i) Due to escalating IT cost in India, HSBC (5 HK) is allocating some IT outsourcing work to CSI and segmental revenue is expected to more than double in FY16F on top of the RMB100 mn in FY15, (ii) The outsourcing agreement with Tencent (700 HK) on game development is progressing well. Given that Tencent shall maintain 30% online game growth, we expect outsourcing revenue from Tencent can grow 50% in FY16F, and (iii) Increasing outsourcing order from Ping An Bank and mobile payment solutions from China Telecom (728 HK) are also major drivers.

Figure 1: Huawei revenue and CSI revenue from Huawei (RMB): Moving in same direction



Source: Company, Huawei, Weixin news and Core Pacific Yamaichi

Figure 2: Huawei operating margin: Shrinking profitability raises need for outsourcing



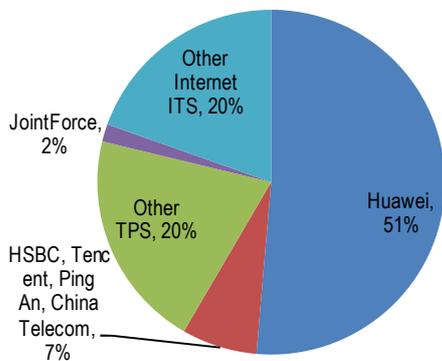
Source: Huawei and Core Pacific Yamaichi

Outsourcing platform JointForce to monetize soon

RMB400 mn revenue from JointForce by FY17F. JointForce (解放號), the online B2B matching platform for IT freelancers unveiled in late 2014, is gaining traction and will become an increasingly important growth driver, which is booked in the Internet IT service segment. The segment reported 11.5%/(5.3)% growth in 1H16 operating profit and revenue to RMB67.6 mn/597 mn respectively, of which the revenue decline was attributed to the fading out of ETC (Excellent Training Center) business. Yet we believe JointForce is entering into harvest period of monetization and management has very buoyant expectation on its near term growth. Many large enterprises such as Yonyou and Founder are now using JointForce as a platform to outsource. Though we only project RMB100 mn/400 mn revenue in FY16F/17F, we reckon JointForce can give a meaningful boost to bottom line once achieving scale economies due to its platform based nature and hence significantly better profitability. We forecast -3.6%/19%/17.5% segmental growth for Internet ITS business from FY16F - 18F, as mainly driven by JointForce.

Ample room of monetization from JointForce as a IT outsourcing matching platform. Being a matching and trading platform for IT project outsourcing, JointForce can help solve the bottleneck of cost control through competitive bidding and project matching, particularly that JointForce now achieves 30% lower project quotation than market average and matching commitment within 72 hours. We argue CSI made a smart move by leaning on a platform based model to make use of its expertise on IT outsourcing, while maximizing business exposure. JointForce is now monetizing on 10% commission charged or spread on outsourcing projects executed. In medium term, management is looking for further monetization in likes of IT head hunting, online advertising and marketing, startup incubator, and Internet financing etc. Currently JointForce has RMB300 mn worth of work done annually and 8,000 corporate clients, while management is looking for USD1 bn/ 5 mn of US counterparts, Upwork.com, as development benchmark.

Figure 3: Projected FY16F revenue breakdown of CSI



Source: Company and Core Pacific Yamaichi estimates

Figure 4: Screenshot of JointForce as a IT outsourcing matching platform



Source: Company

Profit & loss (Consolidated)					
Year to 31 Dec (RMB mn)	2014	2015	2016F	2017F	2018F
Revenue	4,429	5,129	6,134	8,046	9,846
TPS	3,238	3,781	4,834	6,499	8,028
Internet IT services	1,191	1,348	1,300	1,547	1,818
Gross profit	1,349	1,523	1,705	2,225	2,712
Operating expenses	(949)	(1,001)	(1,122)	(1,424)	(1,684)
Selling and marketing expenses	(220)	(179)	(178)	(217)	(256)
Administrative expenses	(665)	(745)	(853)	(1,086)	(1,280)
R&D expenses	(64)	(78)	(92)	(121)	(148)
Bad debt allowance	(27)	(62)	(80)	(97)	(118)
Core operating profit	373	460	503	704	911
Other income and expenses	56	24	50	30	30
Fair value changes					
in convertibles	1	2	-	-	-
Disposal gain	28	112	-	-	-
Associates	1	2	22	29	37
Net finance expenses	(82)	(88)	(87)	(91)	(91)
Pre tax profit	297	420	488	672	886
Tax	(42)	(87)	(81)	(111)	(146)
Minority interests	(55)	(53)	10	(7)	(10)
Net profit	200	280	418	554	730
Core pre tax profit*	269	306	488	672	886
Core net profit*	172	166	418	554	730
EPS (RMB)	0.107	0.141	0.193	0.241	0.312
Core EPS (RMB)	0.092	0.083	0.193	0.241	0.312

Balance sheet (Consolidated)					
Year to 31 Dec (RMB mn)	2014	2015	2016F	2017F	2018F
Total assets	5,344	6,348	7,107	8,053	9,162
Current assets	3,594	4,346	5,046	6,062	7,226
Inventories	32	30	55	72	89
Trade receivable	1,316	1,429	2,269	2,977	3,643
Contract receivable	1,410	1,517	1,717	2,253	2,757
Cash	834	1,311	924	672	634
Other current assets	2	60	80	89	103
Non-current assets	1,751	2,002	2,061	1,991	1,937
Net PPE	376	577	668	647	628
Intangible assets	1,309	1,279	1,220	1,138	1,062
Salable investments	43	49	60	60	60
Associate interest	10	79	101	130	167
Other non current assets	13	18	12	16	20
Total liabilities	2,643	2,862	3,066	3,452	3,821
Current liabilities	2,329	2,539	2,287	2,658	3,013
Trade payable	772	940	920	1,207	1,477
Contract payable	212	88	129	169	207
Short term debt	1,240	1,297	1,025	1,025	1,025
Short term convertibles	-	90	90	90	90
Tax payable	53	87	81	111	146
Other current liabilities	53	37	43	56	69
Non-current liabilities	314	323	779	794	807
Long term debt	62	263	275	275	275
Convertible notes	194	-	458	458	458
Other Non Current Liabilities	58	60	46	60	74
Total equities	2,701	3,486	4,040	4,602	5,342
Shareholders' equity	2,497	3,247	3,811	4,366	5,096
Share capital	1,743	2,202	2,348	2,348	2,348
Reserves	755	1,046	1,463	2,018	2,748
Minority interests	204	239	229	236	246
Total liabilities and equities	5,344	6,348	7,107	8,053	9,162
Net cash/(debt)	(662)	(339)	(924)	(1,176)	(1,214)
Working capital	1,671	1,883	2,950	3,848	4,693
Net gearing (%)	27	10	24	27	24

Cash flow (Consolidated)					
Year to 31 Dec (RMB mn)	2014	2015	2016F	2017F	2018F
Operating cash flow	75	260	(407)	(73)	151
Profit before taxation	297	420	488	672	886
Depreciation and Amt.	142	143	165	173	165
Change in Working capital	(442)	(212)	(1,066)	(898)	(845)
Interest received	82	88	87	91	91
Tax paid	(42)	(87)	(81)	(111)	(146)
Others	38	(93)	-	-	-
Investment cash flow	(438)	(326)	(297)	(179)	(189)
Capex	(379)	(314)	(197)	(70)	(70)
Interest income	(82)	(88)	(87)	(91)	(91)
Others	22	77	(14)	(18)	(27)
Free cash flow	(304)	(55)	(604)	(143)	81
Financing cash flow	236	518	344	-	-
Change in Debt	317	154	198	-	-
Dividend paid	-	-	-	-	-
Capital raised	29	470	146	-	-
Others	(111)	(106)	-	-	-
Net cash flow	(128)	451	(360)	(252)	(37)

Key ratios					
Year to 31 Dec	2014	2015	2016F	2017F	2018F
Growth (%)*					
Turnover	38.2	15.8	19.6	31.2	22.4
EBIT	55.0	23.2	9.3	40.0	29.4
Pre-tax profit	31.5	13.8	59.5	37.7	31.9
Net profit	16.2	(3.3)	151.5	32.7	31.7
EPS	10.3	(9.4)	130.9	25.2	29.5
Margins (%)*					
Gross	30.5	29.7	27.8	27.7	27.6
EBIT	8.4	9.0	8.2	8.8	9.3
Pre-tax profit	6.1	6.0	8.0	8.4	9.0
Net profit	3.9	3.2	6.8	6.9	7.4
Others (%)					
Effective tax rate	15.7	28.4	16.5	16.5	16.5
Payout ratio	-	-	-	-	-
Average RoE	7.2	5.8	11.8	13.6	15.4
Average RoA	3.4	2.8	6.2	7.3	8.5
Interest cover (x)	5	5	6	8	10

Key assumptions					
Year to 31 Dec	2014	2015	2016F	2017F	2018F
Segmental revenue growth (%)					
TPS	N.A.	16.8	27.9	34.5	23.5
Internet IT Services	N.A.	13.2	(3.6)	19.0	17.5
Major revenue contributor (RMB mn)					
Huawei	1,337	1,950	3,150	4,430	5,650
JointForce	N.A.	N.A.	100	400	700

* Core profit excludes convertible adjustment and disposal gain and is the basis for profitability and growth calculation

Sources: Company data and Core Pacific – Yamaichi estimate

Definitions of Recommendations:

For stock recommendations:

- Buy: +15% or above of expected return over the next 12 months.
- Hold: Between +15% and -5% of expected return over the next 12 months.
- Sell: Potential downside of more than 5% over the next 12 months.

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