

Chinasoft International | 354 HK

Bump on the road

- **Mixed 1H19 results**
- **Huawei's business hits a speedbump; new businesses show progress**
- **Attractive valuation**

Mixed 1H19 results. Chinasoft International (Chinasoft) reported a mixed set of 1H19 results, including a 15% YoY increase in the topline to RMB5.54b. Growth in the half was c.5% ahead of Bloomberg consensus and our estimate due to better-than-expected revenue contributed by Huawei, which saw 25% YoY growth in 1H19 and 30% YoY growth in new business revenue. At RMB363m, the bottom line did not fare so well. We attribute the result, representing only 1% YoY growth, to lowered gross margin associated with Huawei, down c.300 bp YoY, and the company's higher operating expense-to-sales ratio.

Huawei business hits speedbump; new business shows progress. Despite encouraging revenue contributed by Huawei in 1H19, Huawei temporarily cut its labor demand from Chinasoft by c.7% in 1H19, bringing the total from c.32,000 to c.30,000. We expect this trend to reverse in FY20F as the US government and Huawei work out a resolution. Assuming Chinasoft suffers some collateral damage in 2H19F, we model an 8% YoY decline in revenue contributed by Huawei in 2H19F. For Chinasoft's new businesses, notably cloud, big data and industrial internet, revenue growth is on track for 31% YoY in 1H19F, supported by surging demand. We forecast about the same growth rate in 2H19F.

Attractive valuation. After factoring in our updated Huawei revenue and margin assumptions, we lower our FY19F/20F earnings forecast by 10.7%/14.4% YoY. Trading at an undemanding valuation of 11.4x FY19 P/E, we believe Chinasoft's share price has limited downside and significant upside potential in 2H19F and the early part of FY20F as the Huawei situation is resolved and revenue contribution from Chinasoft's new businesses continues to improve, from 15% YoY in FY18 to 20% in FY20F based on our assumptions. After lowering our earnings growth projections, we lower our target P/E multiple from 20x to 15x, bringing it in line with the five-year average. We cut our target price from HK\$6.60 to HK\$5.00 after rolling over to FY20F forecasts.

Forecast and valuation

Year to 31 Dec	2017	2018	2019F	2020F	2021F
Revenue (RMB m)	9,244	10,585	12,003	13,604	15,323
YoY (%)	36.3	14.5	13.4	13.3	12.6
Net profit (RMB m)	566	716	721	799	921
YoY (%)	27.9	26.6	0.7	10.9	15.2
Fully diluted EPS (RMB)	0.22	0.26	0.27	0.29	0.34
YoY (%)	9.0	19.4	3.2	10.9	15.2
P/E (x)	14.1	11.8	11.4	10.3	8.9
DPS (HK\$)	0.02	0.02	0.02	0.02	0.03
Dividend yield (%)	0.5	0.6	0.6	0.7	0.8
P/B (x)	1.6	1.4	1.3	1.1	1.0
ROAE (%)	12.0	12.9	11.4	11.4	11.8
Net debt/equity (%)	-21.0	-16.1	-18.1	-18.7	-20.0

Source: Bloomberg, CCBIS estimates

Outperform (maintained)

Current price:

HK\$3.64

(as at 19 Aug 2019)

Target:

► **HK\$5.00**

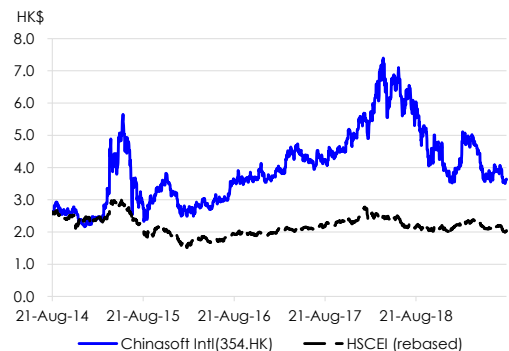
(down from HK\$6.60)

Trading data

52-week range	HK\$3.37–6.37
Market capitalization (m)	HK\$10,114/US\$1,300
Shares outstanding (m)	2,779
Free float (%)	80
3M average daily T/O (m share)	14.7
3M average daily T/O (US\$ m)	8.4
Expected 12-month return (%)	37

Source: Bloomberg, CCBIS estimates

Share price vs HSCEI



Source: Bloomberg, CCBIS

Stock performance

Performance over	1M	3M	12M
Absolute	-6	1	-35
Relative (%) to HSCEI	0	5	-30

Source: Bloomberg, CCBIS

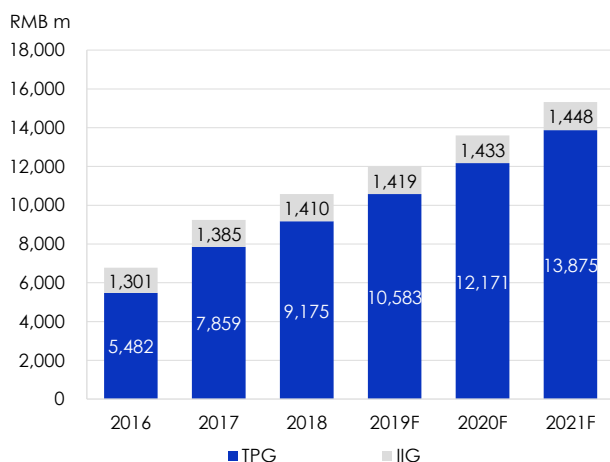
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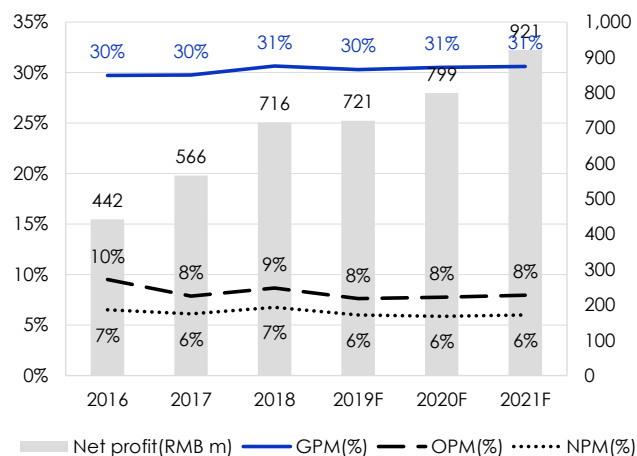
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Chinasoft – revenue mix (RMB m)



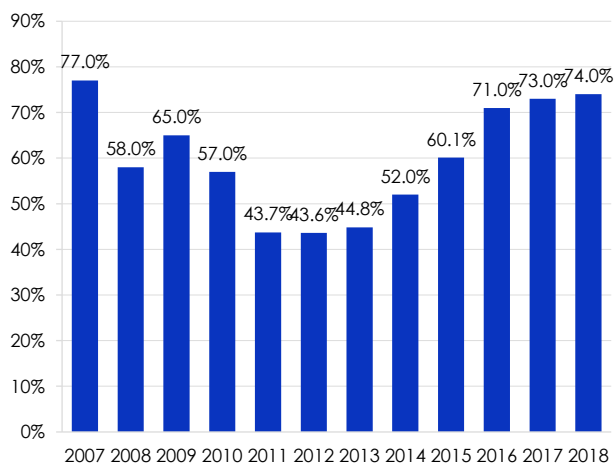
Source: Company data, CCBIS estimates

Chinasoft – net income (RMB m) and margin ratios



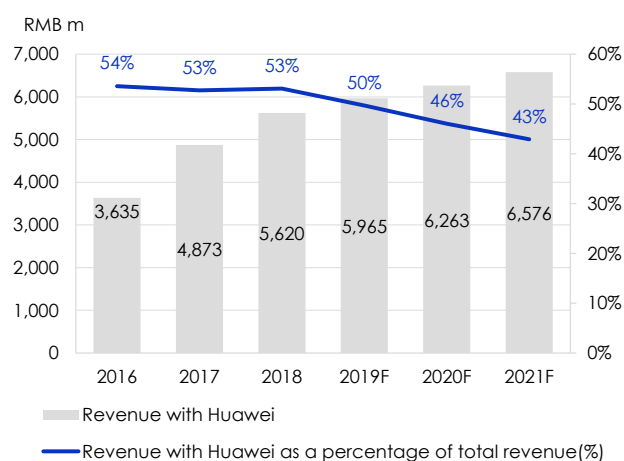
Source: Company data, CCBIS estimates

Chinasoft – top-10 customers by revenue contribution (%)



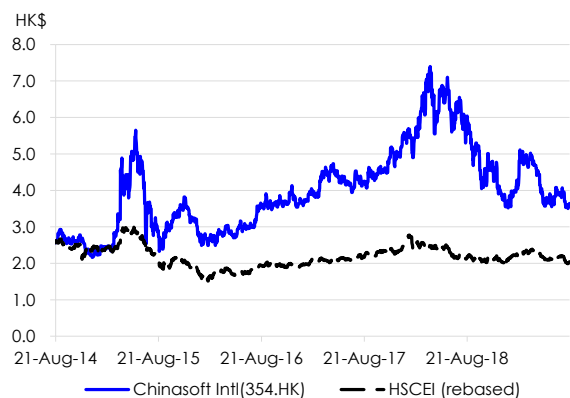
Source: Company data, CCBIS

Chinasoft – revenue from Huawei



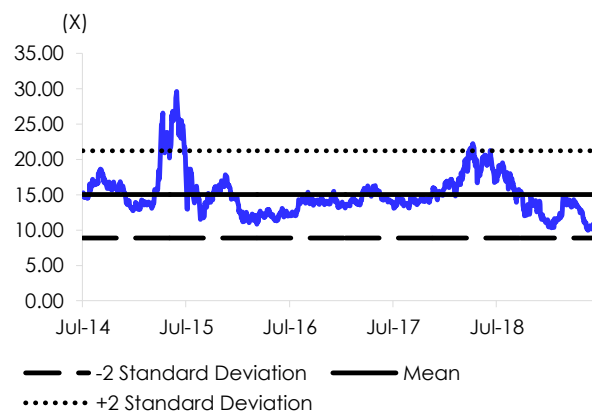
Source: Company data, CCBIS estimates

Chinasoft – price performance vs. HSCEI



Source: Bloomberg, CCBIS

Chinasoft – 5-year P/E bands



Source: Bloomberg, CCBIS

Chinasoft International – earnings revisions

Profit and loss	New forecast			Previous forecast			Change (%)		
	2019F	2020F	2021F	2019F	2020F	2021F	2019F	2020F	2021F
RMB m									
Revenue	12,003	13,604	15,323	11,859	13,283	14,885	1.2	2.4	2.9
Gross profit	3,635	4,149	4,689	3,635	4,091	4,614	0.0	1.4	1.6
Opex	-2,721	-3,095	-3,471	-2,592	-2,876	-3,200	5.0	7.6	8.4
Operating profit	914	1,054	1,218	1,042	1,215	1,414	-12.3	-13.2	-13.9
Net profit	721	799	921	807	933	1,104	-10.7	-14.4	-16.6
%									
Gross margin	30.3	30.5	30.6	30.7	30.8	31.0	-	-	-
OPEX to sales	-22.7	-22.8	-22.7	-21.9	-21.7	-21.5	-	-	-
OPM	7.6	7.8	8.0	8.8	9.2	9.5	-	-	-
Net margin	6.0	5.9	6.0	6.8	7.0	7.4	-	-	-

Source: CCBIS estimates

Software sector peer comparisons

Year ended 31 Dec	Stock code	CCBIS rating#	Share price* (LC)	Market cap (US\$ m)	FY19F	P/E (x) FY20F	FY21F	EPS growth (%)		
								FY19F	FY20F	FY21F
HK listed										
TravelSky	696 HK	Not Rated	15.16	5,655	15	13	12	3	14	14
Kingsoft Corp	3888 HK	Outperform	15.80	2,765	27	19	16	213	43	17
Chinasoft International	354 HK	Outperform	3.64	1,300	11	10	9	3	11	15
Kingdee	268 HK	Neutral	7.80	3,297	63	53	41	-1	19	27
Digital China	861 HK	Not Rated	3.95	841	17	13	N/A	15	30	N/A
Sinosoft	1297 HK	Not Rated	2.04	318	7	6	4	31	31	27
Chanjet	1588 HK	Not Rated	8.52	236	N/A	N/A	N/A	N/A	N/A	N/A
Average					23	19	16	45	26	21
A-share listed										
iFlytek	002230 CH	Outperform	33.07	10,321	85	56	41	41	52	35
Wangsu	300017 CH	Underperform	10.23	3,530	24	25	22	22	-2	13
Aisino	600271 CH	Not Rated	22.04	5,822	21	18	15	26	18	N/A
Hundsun	600570 CH	Not Rated	71.95	8,196	60	47	36	54	28	32
Yonyou	600588 CH	Outperform	31.58	11,135	86	69	54	44	26	27
Shiji info	002153 CH	Not Rated	34.21	5,180	68	56	45	15	21	24
Neusoft Corp	600718 CH	Not Rated	11.09	1,954	32	25	N/A	308	28	N/A
Teamsun	600410 CH	Not Rated	11.11	1,731	N/A	N/A	N/A	N/A	N/A	N/A
YGsoft Inc	002063 CH	Not Rated	8.98	1,082	35	N/A	N/A	N/A	N/A	N/A
Average					51	42	36	73	25	26
Global peers										
Microsoft	MSFT US	Not Rated	138.41	1,056,817	26	23	21	15	13	13
Oracle	ORCL US	Not Rated	53.87	179,701	14	13	12	13	7	4
IBM	IBM US	Not Rated	135.04	119,629	10	10	9	-5	4	6
SAP	SAP US	Not Rated	119.70	147,052	25	23	20	7	10	12
Accenture	ACN US	Not Rated	195.18	131,348	27	24	22	9	9	9
Salesforce	CRM US	Not Rated	143.67	125,747	52	44	34	6	18	28
Workday Inc.	WDAY US	Not Rated	187.64	42,407	111	84	61	34	32	39
Netsuite	N US	Not Rated	109.54	8,865	202	143	96	158	42	49
Average					58	45	34	30	17	20

* Price as at close on 19 Aug 2019 (local currency)

Source: Bloomberg, CCBIS estimates

Chinasoft International – P&L assumptions

RMB m	FY16	FY17	FY18	FY19F	FY20F	FY21F	1H18	2H18	1H19	2H19F
Revenue breakdown										
TPG business	5,482	7,859	9,175	10,583	12,171	13,875	4,029	5,146	4,748	5,835
IIG business	1,301	1,385	1,410	1,419	1,433	1,448	785	626	790	629
Total revenue	6,783	9,244	10,585	12,003	13,604	15,323	4,814	5,771	5,538	6,464
YoY (%)	32	36	15	13	13	13	16	13	15	12
Cost of revenues	-4,768	-6,493	-7,340	-8,367	-9,455	-10,634	-3,424	-3,917	-3,971	-4,396
Gross profit	2,016	2,750	3,245	3,635	4,149	4,689	1,390	1,855	1,567	2,069
Gross profit margin (%)	30	30	31	30	31	31	29	32	28	32
Sales and marketing expense	-219	-370	-496	-557	-619	-697	-233	-263	-266	-291
General & administrative expense	-807	-1,086	-1,091	-1,350	-1,524	-1,701	-680	-411	-833	-517
Research and development	-345	-567	-739	-815	-952	-1,073	0	-739	0	-815
Total operating expense	-1,371	-2,023	-2,326	-2,721	-3,095	-3,471	-913	-1,413	-1,099	-1,623
Operating profit	645	727	919	914	1,054	1,218	477	441	468	446
Operating profit margin (%)	10	8	9	8	8	8	10	8	8	7
Other income, gains and losses	44	96	64	120	105	100	19	45	60	60
Allowance for doubtful debts	-18	-26	0	0	0	0	0	0	0	0
Other expenses	-88	-82	-68	-50	-50	-50	-37	-32	-30	-20
Finance costs	-96	-103	-118	-145	-140	-135	-59	-59	-85	-60
Share of results of associates	17	20	12	-8	0	0	-15	27	-8	0
Loss arising from changes in fair value of contingent consideration payable on acquisition of a subsidiary	20	0	0	0	0	0	0	0	0	0
Profit before tax	525	633	760	801	929	1,083	388	372	390	411
Taxation	-115	-71	-44	-81	-130	-162	-33	-12	-31	-49
Effective tax rate (%)	-22	-11	-6	-10	-14	-15	-8	-3	-8	-12
Net income	410	561	716	721	799	921	356	360	359	362
- Minority interests	-32	-4	0	0	0	0	-3	3	-4	0
Net income attributable to common shareholders	442	566	716	721	799	921	359	357	363	362
YoY (%)	58	28	27	1	11	15	46	12	1	1
Net profit margin (%)	7	6	7	6	6	6	7	6	6	6
EPS diluted (HK\$)	0.22	0.26	0.29	0.30	0.33	0.38	0.15	0.15	0.15	0.15
Diluted share volume (m)	2,400	2,621	2,779	2,711	2,711	2,711	2,789	2,779	2,711	2,711
Key ratios (%)										
EPS growth	36	17	13	3	11	15	30	0	2	3
Gross profit margin	30	30	31	30	31	31	29	32	28	32
Operating profit margin	10	8	9	8	8	8	10	8	8	7
Net profit margin	7	6	7	6	6	6	7	6	6	6
ROAE	12	12	13	11	11	12	N/A	N/A	N/A	N/A
Net debt-to-equity	-4	-21	-16	-18	-19	-20	N/A	N/A	N/A	N/A

Source: Company data, CCBIS estimates

Chinasoft Intl. | 354 HK – financial summary

Profit and loss

FYE 31 Dec (RMB m)	2017	2018	2019F	2020F	2021F
TPG business	7,859	9,175	10,583	12,171	13,875
IIIG business	1,385	1,410	1,419	1,433	1,448
Revenue	9,244	10,585	12,003	13,604	15,323
COGS	(6,493)	(7,340)	(8,367)	(9,455)	(10,634)
Gross profit	2,750	3,245	3,635	4,149	4,689
Operating expenses	(2,023)	(2,326)	(2,721)	(3,095)	(3,471)
EBIT	727	919	914	1,054	1,218
Net financial inc. (exp.)	(103)	(118)	(145)	(140)	(135)
Other	9	(40)	33	15	–
Profit before tax	633	760	801	929	1,083
Tax	(71)	(44)	(81)	(130)	(162)
Total profit	561	716	721	799	921
Minority interest	4	(0)	–	–	–
Net profit attributable to shareholders	566	716	721	799	921
Diluted EPS (RMB)	0.22	0.26	0.27	0.29	0.34
Dividend (RMB m)	39	52	50	56	64
Dividend per share (RMB)	0.02	0.02	0.02	0.02	0.02

Cash flow

FYE 31 Dec (RMB m)	2017	2018	2019F	2020F	2021F
Profit before tax	633	760	801	929	1,083
Amortization & depreciation	178	192	207	223	239
Net financial charge adj.	103	118	145	140	135
Non-cash items adjusted	154	67	–	–	–
Change in working capital	(687)	(743)	(422)	(580)	(624)
Tax paid	(48)	(82)	(81)	(130)	(162)
Other	–	(152)	–	–	–
Operating cash flow	332	161	652	582	670
Capex	(160)	(151)	(160)	(160)	(160)
Other	(74)	(16)	(50)	(50)	(50)
Investment cash flow	(234)	(167)	(210)	(210)	(210)
Change in borrowings	(431)	984	–	–	–
Equity issues	943	109	–	–	–
Dividend paid	(25)	(37)	(52)	(50)	(56)
Other	(54)	(203)	(145)	(140)	(135)
Financing cash flow	432	853	(197)	(190)	(191)
Change in cash flow	530	847	244	182	269
Cash & equivalents, begin	1,299	1,785	2,646	2,891	3,072
Forex	(44)	14	–	–	–
Cash & equivalents, end	1,785	2,646	2,891	3,072	3,341
Free cash flow	(25)	164	448	390	490

Balance sheet

FYE 31 Dec (RMB m)	2017	2018	2019F	2020F	2021F
Cash and equivalents	1,785	2,646	2,891	3,072	3,341
Pledge dep., restrict. cash	1	19	19	19	19
Receivables	4,637	5,495	5,972	6,757	7,599
Inventory	26	64	64	64	64
Total current assets	6,449	8,225	8,946	9,912	11,023
Property, plant and equip.	853	838	865	881	886
Intangible assets	179	148	124	95	60
Other non-current assets	1,271	1,278	1,278	1,278	1,278
Total non-current assets	2,303	2,264	2,266	2,253	2,224
Total assets	8,752	10,488	11,212	12,166	13,248
Short-term borrowings	686	1,676	1,676	1,676	1,676
Trade and bills payable	1,605	1,542	1,598	1,802	2,020
Other current liabilities	262	508	508	508	508
Total current liabilities	2,552	3,726	3,781	3,986	4,203
Other non-current liabilities	970	731	731	731	731
Total non-current liabilities	970	731	731	731	731
Total liabilities	3,522	4,457	4,512	4,717	4,934
Share capital	2,920	3,095	3,095	3,095	3,095
Reserves & retained profits	2,246	2,872	3,540	4,289	5,154
Shareholders' equity	5,166	5,967	6,636	7,384	8,249
Minority interest	64	65	65	65	65
Total equity	5,230	6,032	6,700	7,449	8,314
Total equity and liabilities	8,752	10,488	11,212	12,166	13,248

Ratios

FYE 31 Dec	2017	2018	2019F	2020F	2021F
Growth (%)					
Revenue	36.3	14.5	13.4	13.3	12.6
EBITDA	14.6	22.7	1.0	13.9	14.1
EBIT	12.7	26.3	(0.5)	15.3	15.5
Net profit	27.9	26.6	0.7	10.9	15.2
Profitability (%)					
Gross margin	29.8	30.7	30.3	30.5	30.6
EBITDA margin	9.8	10.5	9.3	9.4	9.5
EBIT margin	7.9	8.7	7.6	7.8	8.0
Net margin	6.1	6.8	6.0	5.9	6.0
Tax rate	11.3	5.8	10.1	14.0	15.0
Efficiency (days)					
Inventory turnover	1	2	3	2	2
Trades receivable	81	79	84	83	83
Trades payable	79	78	68	66	66
Returns & leverage (%)					
ROAA	7.1	7.4	6.6	6.8	7.2
ROAE	12.0	12.9	11.4	11.4	11.8
Net debt (cash)/equity	(21.0)	(16.1)	(18.1)	(18.7)	(20.0)
Liquidity (x)					
Current ratio	2.5	2.2	2.4	2.5	2.6
Quick ratio	2.5	2.2	2.3	2.5	2.6

Source: Company data, CCBIS estimates

Rating definitions:**Outperform (O) – expected return > 10% over the next twelve months****Neutral (N) – expected return between -10% and 10% over the next twelve months****Underperform (U) – expected return < -10% over the next twelve months****Analyst certification:**

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