3 FEBRUARY 2018

CHINA / SOFTWARE & SERVICES

CHINASOFT INTERNATIONAL 354 HK

BUY

TARGET PRICE	HKD6.70
UP/DOWNSIDE	+22.9%
CLOSE	HKD5.45

IT solutions provider at an inflexion

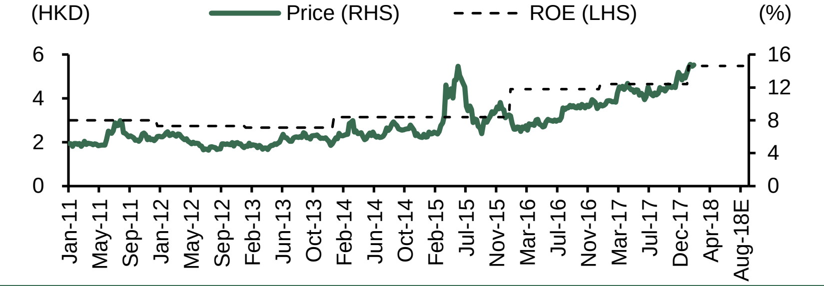
- **An IT solutions provider well positioned for growth trends**
  Chinasoft has evolved from a pure IT services vendor to a solutions provider over the past eight years. As a strategic partner of Huawei, it should benefit from ongoing China market growth and digitalisation in the IT services space. We forecast a 31% FY17-19 net income CAGR with ROE expanding to 16.3% in FY19, from 11.8% in FY16.

- **A beneficiary of IT outsourcing and digitalisation in China**
  IT services are set to grow more in China than globally or in the US over the next few years (11% 2016-21E revenue CAGR vs 4.7% globally and 5.0% for the US, as per Gartner). This is due to China's low base and strong cloud demand. We expect Chinasoft to ride the digital trend given its local advantage, 15-year experience in various industries, and close partnership with Huawei Development Cloud.

- **Strong customer portfolio creates overseas opportunities**
  We find Chinasoft well placed to expand both overseas, given a strong customer portfolio (Huawei, HSBC, Tencent, etc), and locally, with rising demand from Chinese enterprises, and by partnering with local governments. We think investors are overlooking its potential GM expansion via product mix and cheap valuations vs global peers.

- **Initiate at BUY with a HKD6.70 TP: re-rating on ROE expansion**
  We set our TP at 17x FY18E P/E, broadly in line with HK peers. We expect the stock to re-rate given steady earnings growth, stable margins and ROE, balance sheet and cash flow expansion. BUY.

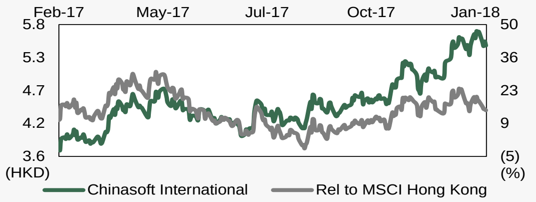
Chinasoft – Price versus ROE



Sources: Bloomberg; BNP Paribas estimates

KEY STOCK DATA

YE Dec (RMB m)	2016A	2017E	2018E	2019E
Revenue	6,783	9,021	10,929	13,084
Rec. net profit	442	567	747	974
Recurring EPS (RMB)	0.20	0.24	0.31	0.41
EPS growth (%)	44.7	16.0	31.7	30.4
Recurring P/E (x)	21.6	18.6	14.1	10.8
Dividend yield (%)	0.3	0.3	0.4	0.5
EV/EBITDA (x)	13.8	13.6	10.6	8.1
Price/book (x)	2.2	2.2	1.9	1.6
Net debt/Equity (%)	1.4	12.9	8.3	0.4
ROE (%)	11.8	12.5	14.5	16.3



Share price performance	1 Month	3 Month	12 Month
Absolute (%)	5.0	18.2	46.9
Relative to country (%)	1.1	8.6	14.2

Next Results	April 2018
Mkt cap (USD m)	1,674
3m avg daily turnover (USD m)	9.8
Free float (%)	88
Major shareholder	Chen YuHong (11%)
12m high/low (HKD)	5.69/3.70
3m historic vol. (%)	33.2
ADR ticker	-
ADR closing price (USD)	-
Issued shares (m)	2,402

Sources: FactSet estimates; BNP Paribas estimates

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Investment thesis

We initiate coverage of Chinasoft, a leading IT solutions provider in China, with a BUY rating and target price of HKD6.70 set at 17x FY18E P/E, implying 23% upside potential. We expect the stock to re-rate on the company's solid position from which to capture rising digitalisation demand and ROE expansion.

1) Proxy for ongoing IT services expansion in China As China's leading IT solutions provider, we believe Chinasoft should continue to deepen relationships with key clients (Huawei, HSBC, Microsoft, China Mobile, Tencent, etc) and expand overseas. IT services should grow more in China than globally or in the US (11% 2016-21E revenue CAGR vs 4.7% and 5.0%, as per Gartner).

2) Benefitting from digitalisation of IT services The digital trend in IT services represents a strong opportunity for Chinasoft, as internet-related trends are redefining and boosting demand for IT services vs its legacy business.

3) Better positioned than peers Chinasoft is well placed to compete both overseas and locally, given its local vendor advantage, strong know-how in various industries, the growth of its ecosystem (JointForce), and partnership with Huawei.

Catalyst

We expect positive catalysts to be:

1 Strong FY17 earnings with margin expansion

2 China cloud services market growth

3 Gaining new clients and/or new government projects

Risk to our call

Downside risks to our P/E-based TP include: 1) increased labour costs in China, 2) ASP erosion from competition, 3) weaker-than-expected cloud services adoption in China, 4) a weakening macro economy in China, and 5) market share loss at key clients.

Company background

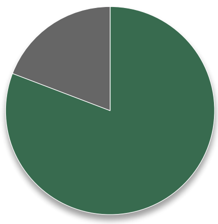
Established in 2000 and listed in 2004, Chinasoft is leading company in China to provide IT services and develop software among key verticals.

Key executives

	Age	Joined	Title
Chen YuHong	55	2000	Chairman/ CEO
Tang Zhenming	55	2000	Executive Director
Simon Zhang	55	2000	Senior Vice President
Simon Chung	56	2006	Global COO
Leong Leung Chai	38	2017	Deputy CFO

http://www.chinasofti.com/en/

Principal activities (revenue, 2016)



Source: BNP Paribas estimates

Event calendar

Date	Event
Apr 2018	2H17 Chinasoft earnings release
Aug 2018	1H18 Chinasoft earnings release

Key assumptions

Sales (RMB m)	2016	2017E	2018E	2019E
TPG	5,137	6,678	7,680	8,601
TPG (Big data)	195	302	402	502
TPG (Cloud Service)	150	300	570	969
IIG (excluding JF)	1,107	1,362	1,621	1,913
JointForce	100	292	584	1,034
Total sales	6,783	9,021	10,929	13,084
Change (y-y %)	32.3	33.0	21.1	19.7
GM (%)	29.7	29.7	29.8	29.9
OPM (%)	9.5	8.4	8.9	9.4

Sources: Chinasoft International; BNP Paribas estimates

Earnings sensitivity

	------------- FY17E -------------			------------- FY18E -------------		
(%)	Bear	Base	Best	Bear	Base	Best
Revenue growth	29.0	33.0	37.0	17.1	21.1	25.1
Gross margin	28.2	29.7	30.4	28.3	29.8	30.6
Net margin	4.2	6.3	7.8	4.7	6.8	8.4
Upside/downside	(33.5)	0.0	23.8	(31.4)	0.0	22.7

Source: BNP Paribas estimates

- Key earnings drivers are revenue growth and margins.
- In our best case scenario, we forecast 2018 y-y revenue growth/GM of 25.1%/30.6%, which would increase our earnings estimate by 22.7%, all else being equal.
- In our bear case scenario, we forecast 2018 y-y revenue growth/GM of 17.1%/28.3%, which would decrease our earnings estimate by 31.4%, all else being equal.

CONTENTS

Investment summary

We initiate coverage on Chinasoft, a leading IT solutions provider in China and Huawei's largest IT outsourcing partner, at BUY with a HKD6.70 TP, implying 23% upside potential. Chinasoft posted a revenue CAGR of 28% over FY13-16 and we forecast an earnings CAGR of 31% over 2017-19, driven by: 1) continued IT service market expansion in China, and 2) increasing internet IT services demand. The stock is trading at 14.1x FY18E P/E and we expect it to re-rate given the company's: a) solid positioning for demand resulting from digitalisation of IT services, and b) ongoing ROE expansion.

Key investment rationale

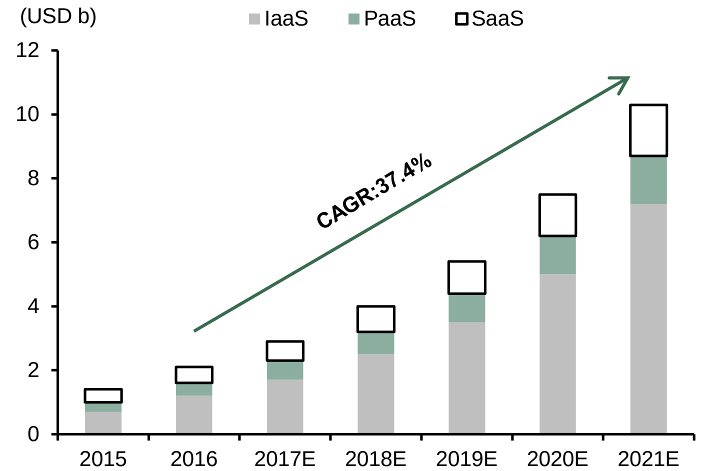
Proxy for ongoing IT services expansion in China: We see Chinasoft as a major beneficiary of the expanding China IT service market and digitalisation trend within IT services. Gartner forecasts a c11% revenue CAGR for the IT services market in China in 2016-21E, much stronger than globally (4.7%) and in the US (5.0%). As China's leading player, we expect Chinasoft to deepen relationships with key clients (Huawei, HSBC, Microsoft, China Mobile, Tencent, etc) and to grow overseas.

Benefitting from digitalisation of IT services: We expect the digital trend in IT services to mean opportunities for Chinasoft as internet-related trends (cloud computing, IoT, social media and big data) have all redefined IT services. IT services vendors have had to evolve and their platforms have had to incorporate security systems, applications and services. China's cloud market seems under-developed, as the Software-as-a-Service (SaaS) market was 50-60 times bigger in the US than in China in FY16, as per Gartner. For Chinasoft, we forecast internet IT services will deliver 31%/32% sales growth in FY18/19 with a sales contribution rising to 23% in FY19 from 19% in FY16.

Better positioned than peers: Chinasoft has evolved from a pure IT outsourcing vendor to a total solutions provider over the past eight years. It has an end-to-end business model including consulting, solutions, outsourcing and training services for clients. Despite China's fragmented IT outsourcing market, we think Chinasoft is well positioned to compete overseas and locally in the long run, supported by local vendor advantage, better know-how among various industries, the growth of its own ecosystem (JointForce), and partnership with Huawei. Chinasoft also stands to benefit from the "one belt one road" policy and the smart city trend in China.

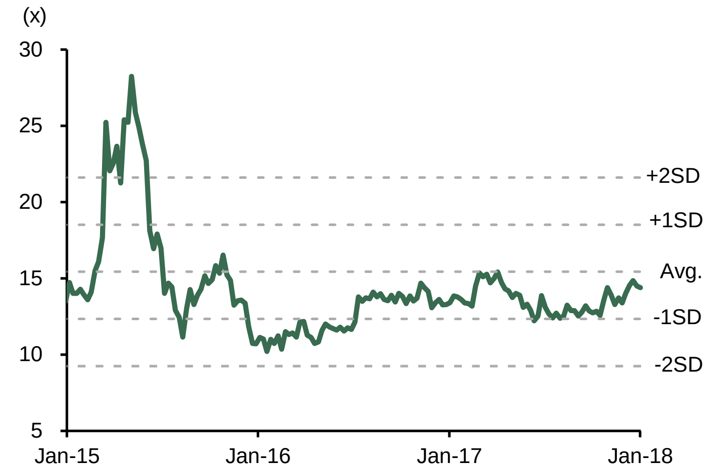
Re-rating on ROE expansion: initiate coverage at BUY with an HKD6.70 TP: Chinasoft is trading at 14.1x FY18E /PE, at the lower end of its historical range and below the global peer average at 19x and HK peer average of c18x. We believe current valuations are not demanding and that our target 17x FY18E P/E is justified by our forecast earnings CAGR of 31% over FY17-19 and continued ROE expansion to levels above most key Chinese players in 2017-19E. We expect the stock to re-rate given its solid positioning for the digitalisation trend and ongoing ROE expansion.

Exhibit 1: China public cloud market growing fast



Sources: Gartner

Exhibit 2: Historical 12M forward P/E bands

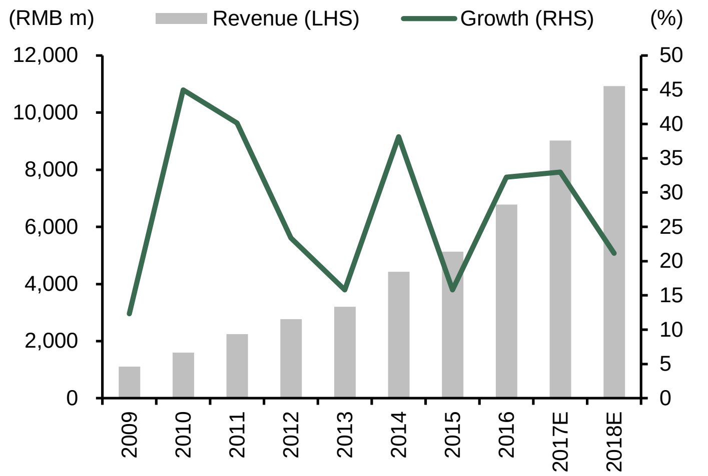


Sources: Bloomberg; BNP Paribas

A leading information technology solutions provider

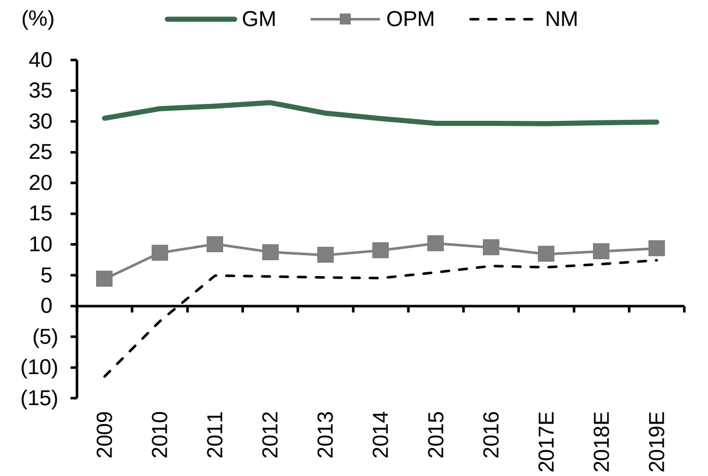
Founded in 2000, Chinasoft International is a leading information technology (IT) service provider in China. Chinasoft has accumulated more than 15 years of experience in IT outsourcing and 8 years of experience in solutions consulting. Its end-to-end business model provides consulting, solutions, outsourcing and training services for clients. As a strategic partner of Huawei, Chinasoft delivered a 33% revenue CAGR in 2003-2016, with employee headcount expanding from 238 in 2003 to 47,188 at the end of FY16. The company is also engaged in several industries, such as manufacturing, government, public services, high- tech, finance, telecommunications, electricity and internet, well supported by years of experience. Chinasoft plans to deepen the relationship with large clients by leveraging its cloud-based digital transformation services, and to expand globally.

Exhibit 3: Chinasoft – Revenue and growth rate



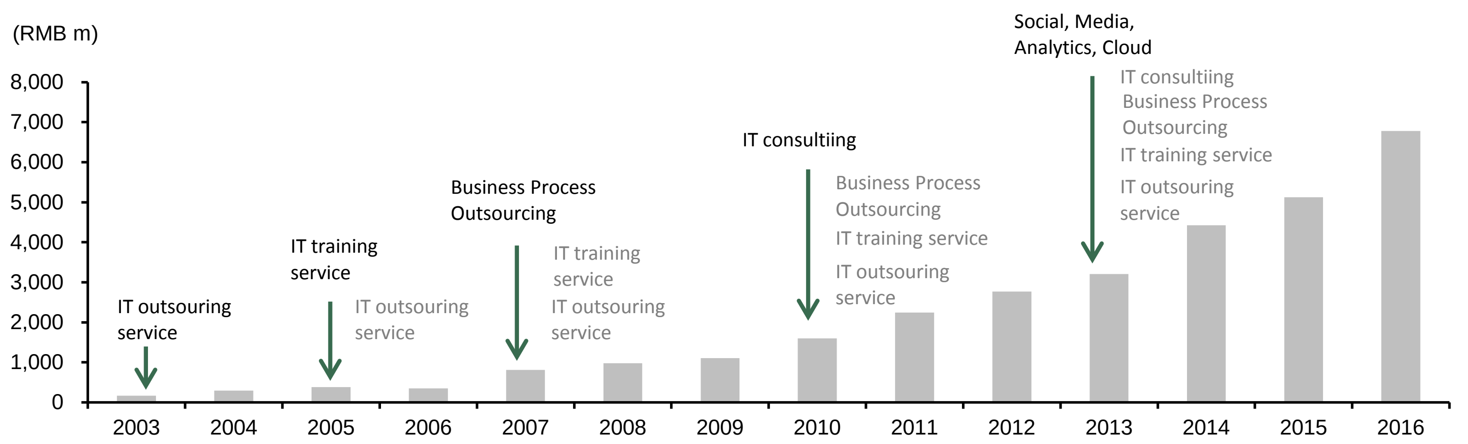
Sources: Chinasoft International; BNP Paribas estimates

Exhibit 4: Chinasoft – stable margin trend



Sources: Chinasoft International; BNP Paribas estimates

Exhibit 5: Relationship between historical revenue and services capabilities



Source: Chinasoft International

What are Chinasoft's services and products?

Chinasoft's business segments are currently divided into Technical and Professional Service Group (TPG) and the Internet IT Service Group (IIG). TPG is mainly a consulting-driven model, which is based on independently developed software platform products. Generally, TPG services can enhance clients' productivity through IT solutions or merely provide IT engineering services to reduce costs to develop new information technology. IIG is mainly involved in cloud-related products and an internet-based working platform "JointForce", which was created to cater to smaller-sized projects within IT services' long-tailed Internet market.

Exhibit 6: Chinasoft services segment description

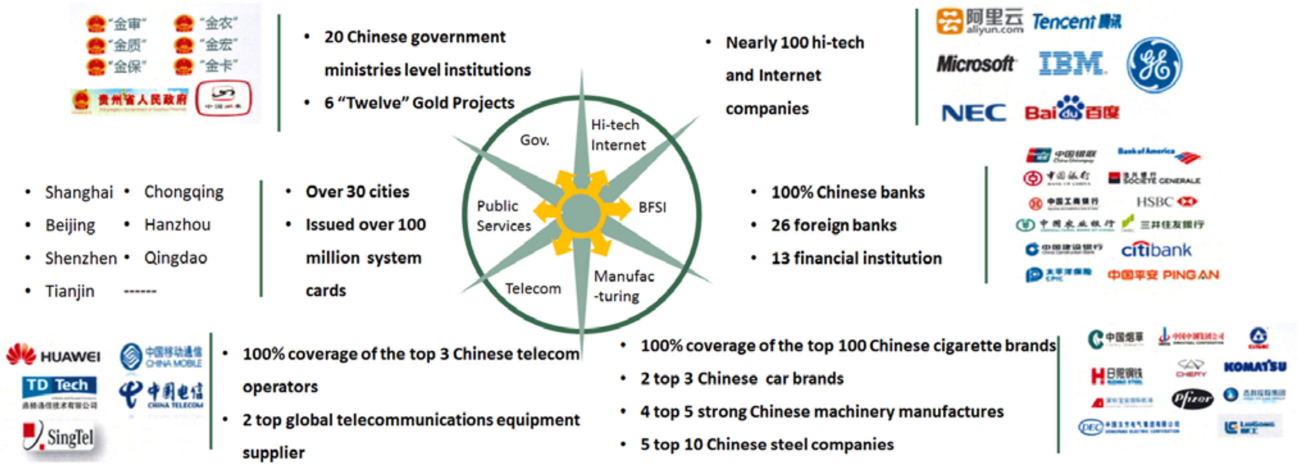
Business Segment	Previous Classification	Description
TPG (Technical and Professional service Group)	1. Professional Services Business (PSG) 2. Outsourcing Services Business (OSG)	▪ Similar to the offline business, TPG includes IT outsourcing services (previously OSG business), IT solutions and IT consulting services (which were classified as PSG business under the previous classification). ▪ Software companies typically outsource application development to IT outsourcing companies in order to speed up product development and reduce the development cost. On the other hand, IT solutions integrate consulting services such as, business intelligence, with implementation to fulfil clients' customised need and increase companies' productivity. ▪ Usually, the tailor-made enterprise-level software will be built on IT outsourcing companies' independently developed software. In Chinasoft's case, these are Toplink and ResourceOne. ▪ In the digital age, Chinasoft also provides the new emerging cloud services and big data analytics to help clients modernise their platform.
IIG (Internet IT service Group)	1. Emerging Services Business (ESG) 2. JointForce	▪ Internet IT services focus on "on-line" business, including JointForce, Cloud-related products such as PaaS (Platform as a service) and SaaS (Software as a service). ▪ JointForce is a platform to meet IT service demand and supply and has been invented to cater to smaller-sized projects within IT services' long-tailed market. ▪ Chinasoft also categorises the cloud consulting and SaaS / PaaS cloud products into IIG (previously classified in ISG business) to amplify the importance of the cloud opportunity, driven by rising demand in cloud computing, data analysis, social & mobile application usage.

Source: Chinasoft International

Impressive customer portfolio

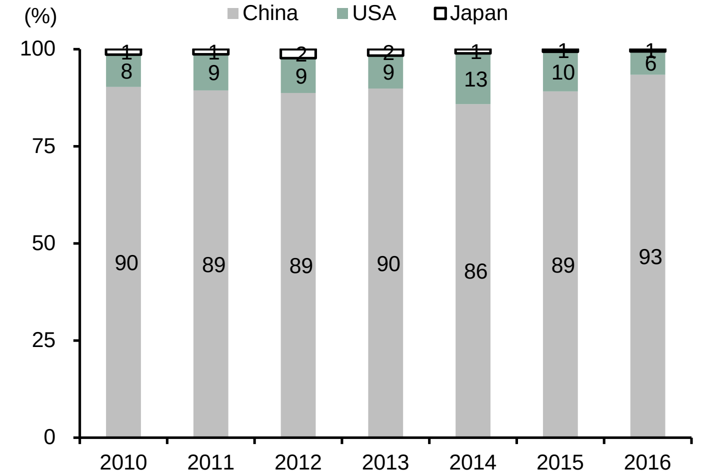
The majority of Chinasoft's IT services customers are China domestic enterprises and institutions, accounting for more than c90% of total revenue since 2010. In 2016, Huawei was the biggest client and accounted for 54% of total revenue, followed by HSBC's 4.4%, Microsoft's 2.3%, Tencent's 2.2%, and others. We think its strong customer portfolio is evidence of its good service quality and leading position in China. Except for the largest client, Huawei, Chinasoft's top 5 customers together only represented c12% of total sales in 2016. In terms of sectors, it has expertise in several industries, such as banking and tobacco. Notably, Chinasoft has established a strong relationship with all the China banks by providing a payment application, based on its self-development operating system, Toplink. Chinasoft also successfully built up relationship with top 100 Chinese cigarettes brands by providing Manufacturing Execution System (MES).

Exhibit 7: Diversified client base from different verticals



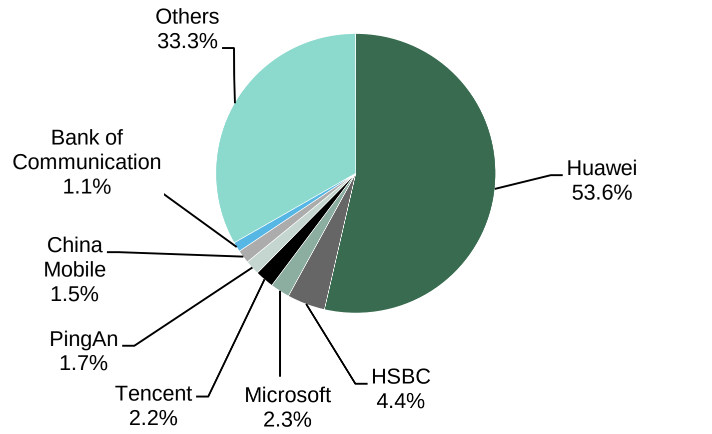
Source: Chinasoft International

Exhibit 8: Revenue mix by region



Source: Chinasoft International

Exhibit 9: Top 7 clients' revenue contribution in FY16



Source: Chinasoft International

Exhibit 10: Key clients portfolio

Key Clients	% of 2016 revenue	Relationship between key clients
Huawei	53.60	Chinasoft entered a joint venture with Huawei in 2012. With the quality of services improving during the cooperation period and recognised by Huawei, Chinasoft took the further step of buying back the joint venture shares, but Huawei then acquired a 3.97% stake in Chinasoft and become one of the major shareholders in 2015. Revenue earned from Huawei has grown to RMB3.6b as of FY16, from RMB99m in 2009. Recently, Chinasoft signed a new agreement to "share the same boat" with Huawei meaning it expects to penetrate the global market with Huawei through further cooperation in software development, cloud solutions and cloud services in the digital era.[see Ex 63 and 64]
HSBC	4.40	Chinasoft became HSBC's only strategic IT partner in 2016, recognising Chinasoft's quality and delivery capability. Chinasoft has developed numerous projects and applications for HSBC, including the Hong Kong Apply pay project, Credit Card System, "SZ-HK Connect" project, China VTM project, China Micro Bank, Electronic Tax system and data warehouse constructions. Revenue generated from HSBC grew 161% y-y in 1H17, as we believe HSBC has given most of its key digital projects to Chinasoft in the transformation era, resulting in a stronger relationship with HSBC and potentially bringing more revenue from software maintenance on previous projects or new application development in the future.
Microsoft	2.30	Chinasoft was the first to become a Global Premier Vendor for Microsoft in 2009. As such, Microsoft converted its preference shares into ordinary shares and strengthened its strategic relationship with Chinasoft. In 2015, Catapult Systems, the US subsidiary of Chinasoft, provided clients with a cloud service called "Fuse" based on Microsoft Azure, which successfully reached 50,000 users in 2016 and effectively helped clients conduct their own digital transformation. Microsoft held 97m shares (4% of total shares) as of 1H17 [see Ex 63 and 64].
Tencent	2.20	Chinasoft entered into a strategic cooperation with Tencent to become the largest IT service supplier for Tencent games in 2014 and became Tencent Cloud's one of the most important channel partners in 2016 according to management, mutually building the enterprise's internet ecosystem. Besides, the retired co-founder of Tencent took part in Chinasoft's latest fundraising initiative, strengthening the relationship between the two companies.
China Mobile	1.50	Chinasoft successfully bid for China Mobile's 139 mailbox project, unified payment project, unified communication project and Fetion Wireless System Product project in 2014, proving Chinasoft's strong product development capabilities and experience in the mobile industry. We believe these projects also give Chinasoft recurring cash flow from maintaining or upgrading the system, increasing its chances of successfully bidding for China Mobile's new projects in the future.
Manufacturing industry	na	Leveraging its comprehensive understanding of manufacturing industries along with its professional IT service capabilities expansion, Chinasoft has built up many proprietary software systems, such as Logistics Execution System (LES) and Manufacturing Execution System (MES) software for the manufacturing industry. Notably, Chinasoft specialises in the tobacco industry, with 100% coverage of the top 100 Chinese cigarette companies. Recently, Chinasoft signed a cooperative contract with local government, such as Kun Shan City, to provide cloud-based enterprise software for manufacturing companies in a local intelligent manufacturing demonstration area, helping these local enterprises start their digital transformation and to catch up with other leading manufacturers in intelligent manufacturing revolution.
Government	na	As a pioneer vendor providing IT services to the government, Chinasoft has leveraged its years of industry experience and its self-developed middleware, ResourceOne, to undertake several key national projects. Besides, Chinasoft has won six National Golden Project Awards for these projects, including awards for auditing, quality, insurance, agriculture, macroeconomic management, and IC card projects.

Source: Chinasoft International

More than just an IT outsourcing services vendor

Chinasoft has accumulated more than 15 years of experience in IT outsourcing and eight years of experience in solutions consulting, and cultivated in-depth expertise in six major segments, including finance, telecom, manufacturing, public services and hi-tech sectors. According to management, it has formed more than 50 standardised industry solutions and over 300 software copyrights. Along with the accumulation of experience in different sectors, Chinasoft's business model has also gradually evolved to cover total solutions, which integrate business consulting and IT outsourcing services. We believe the ability to leverage industry know-how and integrate with IT technology as a total solution provider help distinguish Chinasoft from other IT outsourcing firms. Notably, Chinasoft now can provide Social, Mobile, Analytics, Cloud (SMAC) services to meet the rising IT service demand in the digitalisation era.

Well positioned in smart city concept and One Belt, One Road

Under the smart cities trend, we believe IT services will play a more important role as they can help make government administration, public safety, energy & utilities control and transportation smarter. As such, we expect increasing awareness of smart city concepts to be positive for IT service players, especially leading players such as Chinasoft. Moreover, we see Chinasoft also benefit from the ongoing "One belt One Road" policy, as Chinasoft is one of the most important partners of Huawei, which has been expanding its sales exposure overseas, especially in emerging markets.

Exhibit 11:IT Service to play a key supportive role in smart city concepts

Source: TechTarget

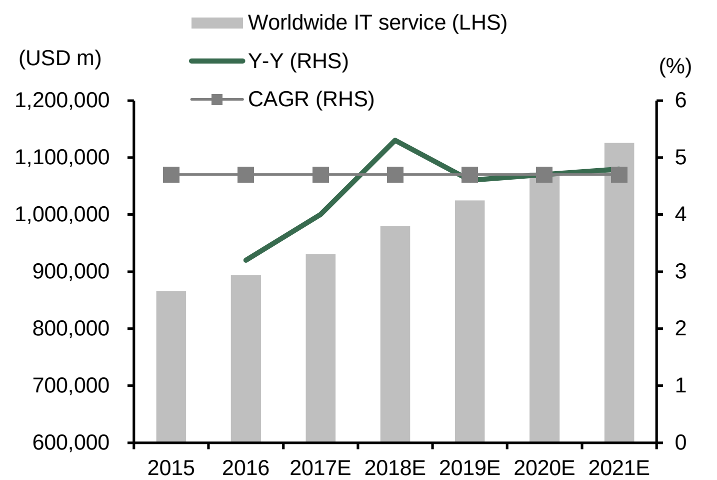
Exhibit 12: One belt, One Road Policy to drive IT investment along with other countries' infrastructure establishment

Source: ChinaDialogue.net

The global IT service market

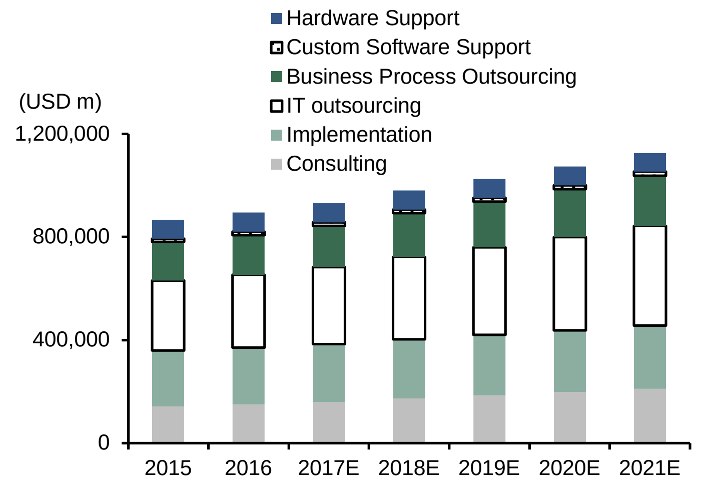
IT services enable organisations to create, manage, optimise and access information and business processes. IT services can be divided into six segments; namely consulting, implementation, IT outsourcing, business process outsourcing (BPO), custom software support, and hardware support, based on Gartner's classification. According to Gartner, the total global IT service market reached USD894b (up 3.2% y-y) in revenue terms in FY16 and Gartner forecasts a 4.7% CAGR in FY16-21, mainly driven by 1) development of advanced techniques from big data analytics, and 2) a higher adoption rate of cloud services among different sectors.

Exhibit 13: Global IT services mkt. growth – low single digits



Source: Gartner

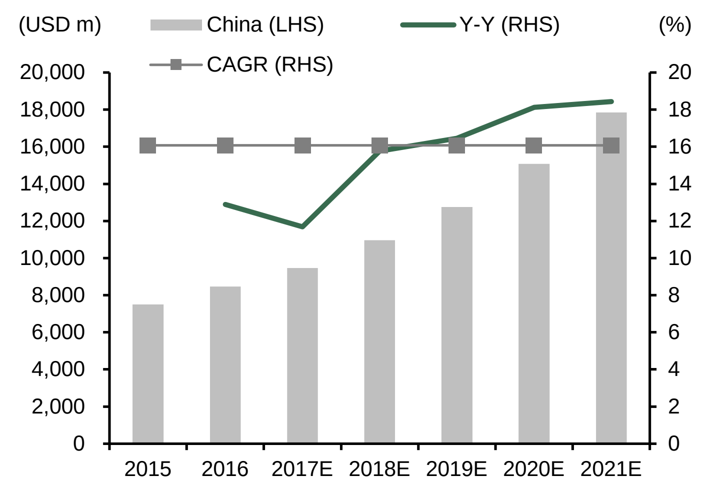
Exhibit 14: IT Revenue by segment



Source: Gartner

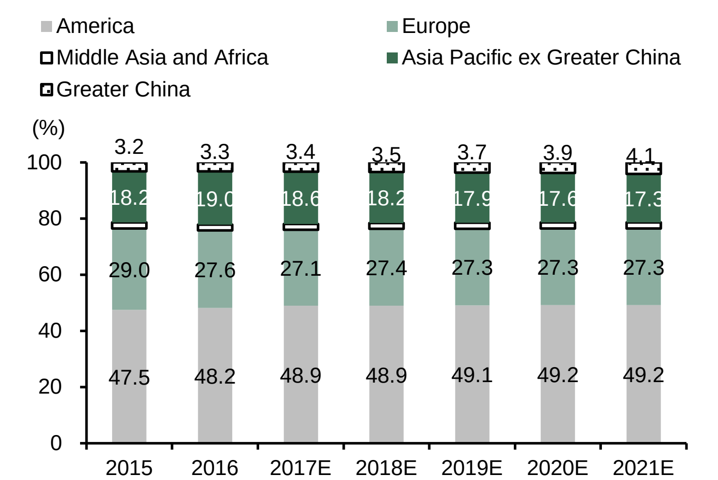
According to Gartner, the US was the biggest IT service market at USD431b in revenue in 2016 and accounted for 48% global market share, followed by Europe's 28%, Asia Pacific's 19%, and Greater China's 3%. Western countries, especially the US, represent the majority of IT service spending as these countries encourage innovation in different businesses. However, given the relatively high base in western countries such as the US, market growth should decelerate to a 5% CAGR in FY16-21, much lower than Greater China's 11%, according to Gartner.

Exhibit 15: China IT outsourcing segment revenue growth



Source: Gartner

Exhibit 16: IT Service market revenue share by region

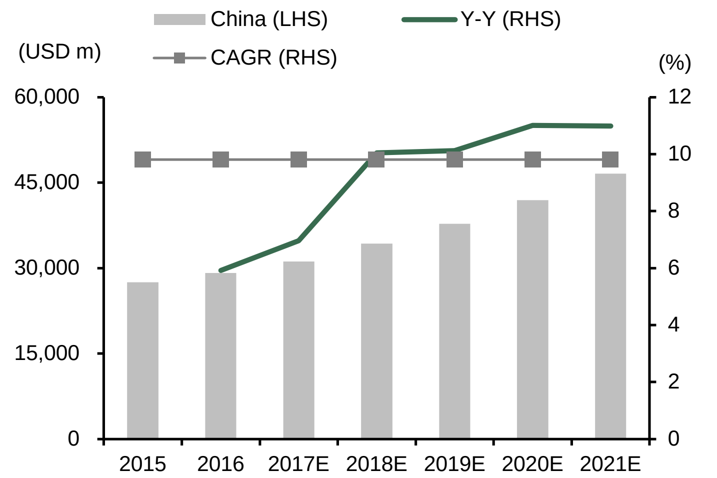


Source: Gartner

China IT services market is growing faster than that of the global market

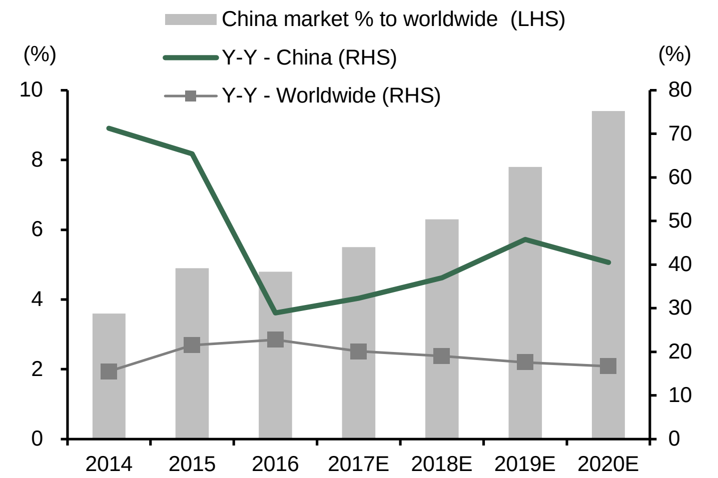
We attribute the stronger IT service market growth in China to 1) its higher-than-global economic growth rate, 2) smaller base of IT service compared with western countries, 3) the rise of China's domestic technology giants, such as Baidu, Alibaba and Tencent, with some advancement in the development of e-commerce, mobile payment, and 4) increasing adoption of cloud solutions in China. Notably, iResearch forecasts the Solutions as a Services (SaaS) market in China will expand to RMB47b in revenue in 2020E, a 41% CAGR from 2017, outpacing the 18% global CAGR.

Exhibit 17: China IT service market size and growth (revenue)



Source: Gartner

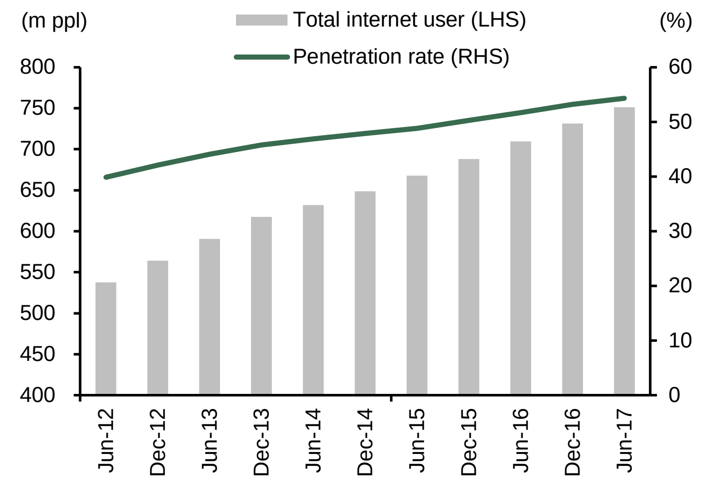
Exhibit 18: SaaS market growth comparison (China vs World)



Source: iResearch

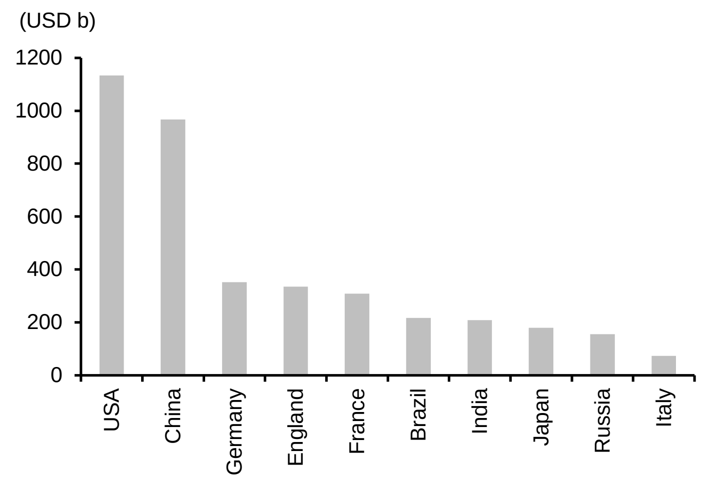
Globally, China offers significant potential in its internet market, as its online consumption ranks second worldwide, just slightly lower than USA but three times higher than the next largest country. China recorded a 25% CAGR in total Internet users in the past 15 years, and now has the most internet users—751m—in the world. However, even with such strong growth, China's internet penetration rate is still just 54.3%, compared with the developed countries' 85%. Therefore, we believe there is still enough room for China's Internet market to grow, which also creates new opportunities in the IT industry.

Exhibit 19: China's Internet user and penetration rate



Source: CNNIC

Exhibit 20: Top 10 countries of consumption through Internet



Sources: CNNIC; Internet Live Stats

China government's attitude also stimulates IT services market growth

At the 19th party congress, President Xi placed strong emphasis on the ongoing digital revolution (integration of the internet, big data, and artificial intelligence) and advanced manufacturing (Intelligent Manufacturing, concept of Internet + Manufacturing) in his speech. China is clearly trying to achieve economic growth and maintain the competitiveness of its economy through digital platform and purchasing quality enhancement. We believe supporting IT services will be one of the government's top priorities in order to pursue sustainable economic growth, which will stimulate potential Internet IT services demand.

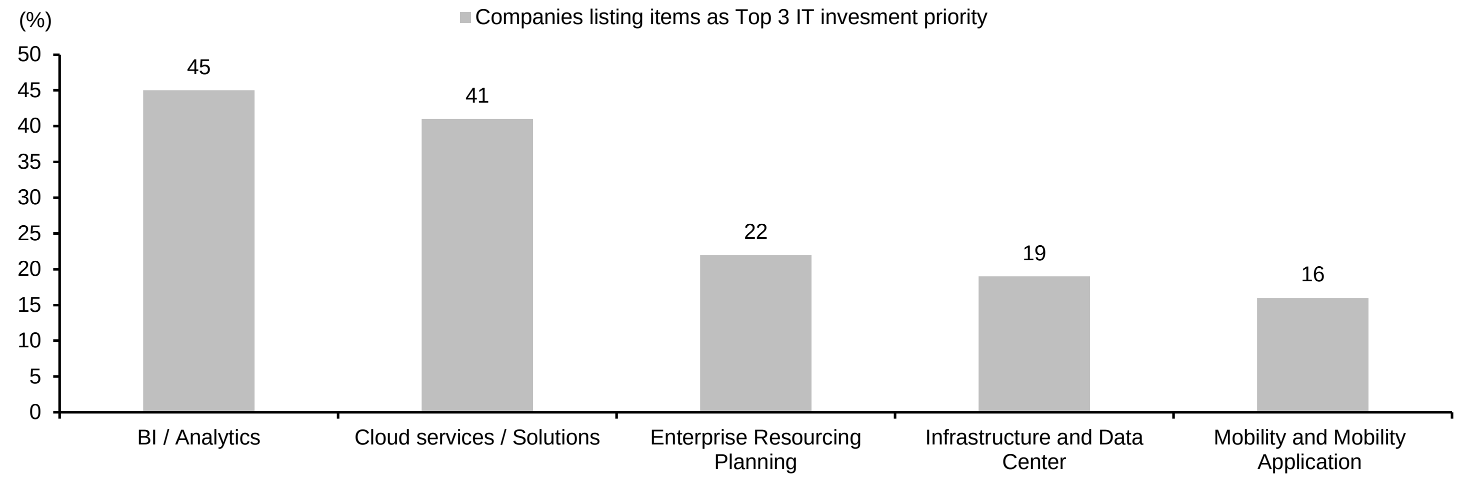
The Internet+ action plan, aiming to integrate the Internet with traditional industries, was announced by premier Li in 2015. The plan is to coordinate mobile internet, cloud computing, big data and the IoT with different sectors, such as e-commerce, industry and banking, to stimulate further economic development and increase China's international position. We expect to see more such supportive policies from the China government.

Cloud-related market growth outpacing the legacy IT service market

Cloud service is currently changing the enterprise business model and creating an additional wave of IT service demand. We believe cloud-related IT services market growth will outpace legacy IT services in the not so distant future. Customers have already altered their shopping behaviour, accompanied by the increasing penetration of mobile internet, which has been driving new IT service demand for e-commerce business models and data-driven decision analytics services. Notably, we see China as the key beneficiary of this trend, as China is a comparatively mature market with the higher adoption rate of mobile payments mainly due to the concern of fake money. We also see more adoption of digital technology from large-sized enterprises, especially the manufacturing industry, and believe it will be an additional driver to boost IT services demand.

Our BNPP IT services analyst, Abhiram Eleswarapu, concluded several key trends in his report: *6th India Technology Tour: opinions galore* (click here): 1) large sized enterprise tech adoption is well behind that of the end consumer, and could lead to a new wave of IT spending; 2) many clients still need handholding in the digital age. As such, we believe it's inevitable for large-sized enterprise to adopt more digital technology to improve the work performance and efficiency, besides lagging consumer-oriented enterprises. Generally, new IT services include cloud service or solutions, business intelligence from big data analytics, and software for smart manufacturing, data centre, and mobility applications, selected by most CIOs in the large-sized enterprises as their top three priorities to invest in IT space, according to Gartner.

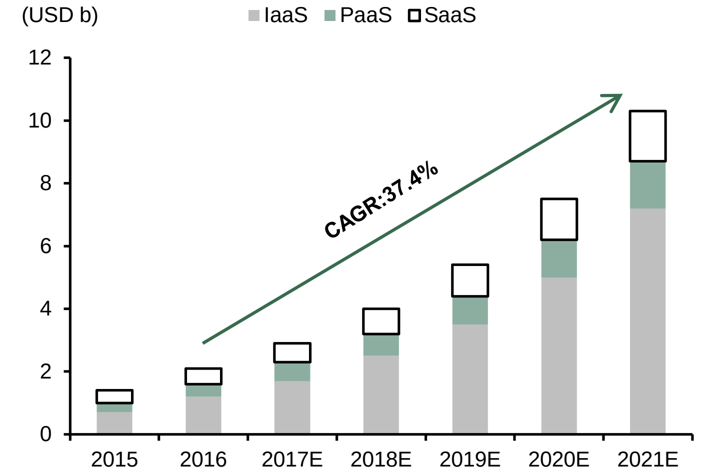
Exhibit 21: Most Important IT categories for companies in China



Source: Gartner

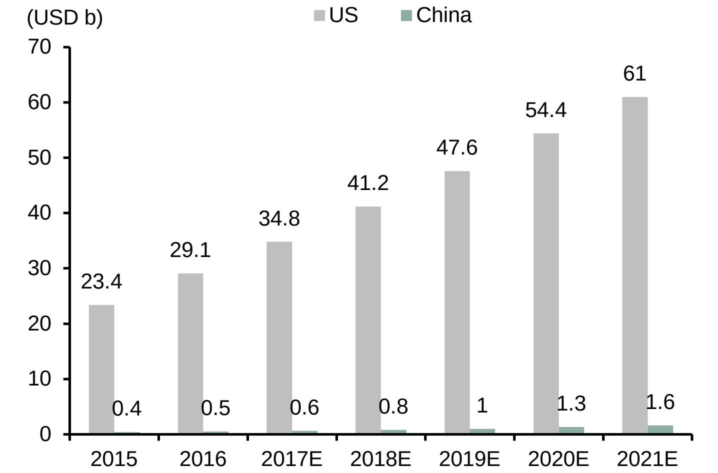
Gartner data suggests China's public cloud service market will expand to USD10.3b in revenue terms in 2021, from USD2.1b in 2016, a 37.4% CAGR. Chinese cloud development still lags that in the US, like other IT development, while the US Software as a Service (SaaS) market was worth USD29.1b in FY16, compared with China's USD0.5b. We believe China's cloud adoption for large-sized enterprises has only just begun, meaning there is much more room for Chinese players to benefit from this rising domestic demand due to their 1) lower service cost, 2) better after-sales services, and 3) local knowledge.

Exhibit 22: China public cloud market revenues



Source: Gartner

Exhibit 23: SaaS market comparison (US vs China revenue)



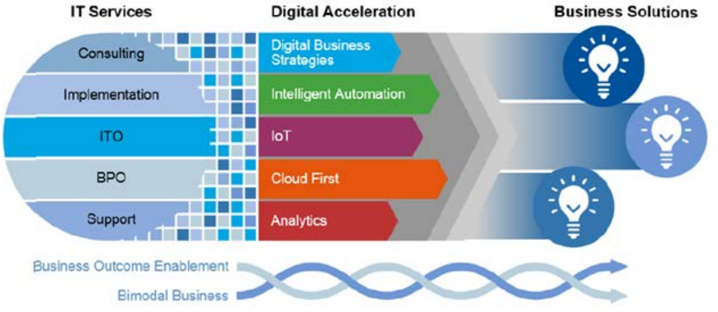
Source: Gartner

Automation: Another key trend that may affect IT services

Most IT outsourcing players are facing sluggish growth from legacy services due to a high base, despite the ever increasing digitalisation transformation requirement. At the same time, IT services players have to deal with 1) wage hikes and 2) price bargaining with clients, who also look for faster execution of services. We believe adoption of automation techniques from IT outsourcing vendors is a primary means of sustaining historical rates of profitability growth. Gartner estimates a majority of services providers will use intelligent automation service techniques to lower the cost of commodity services 15% to 20% annually.

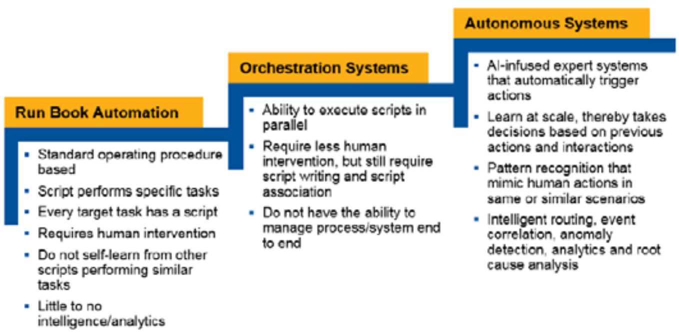
We are in the digital age when most IT outsourcing vendors are eager to equip themselves with the most diversified digital services, to capture the opportunities arising from the growing demand for cloud services, data centre infrastructure, and mobile application development. But, we believe investing in intelligent automation techniques is as important as the digital capabilities in maintaining IT outsourcing players' competency.

Exhibit 24: New IT services dynamics under digital age



Source: Gartner

Exhibit 25: Evolution of Intelligent Automation Services



Source: Gartner

Long-term leader in China

Chinasoft is a potential winner from the IT service digital trend

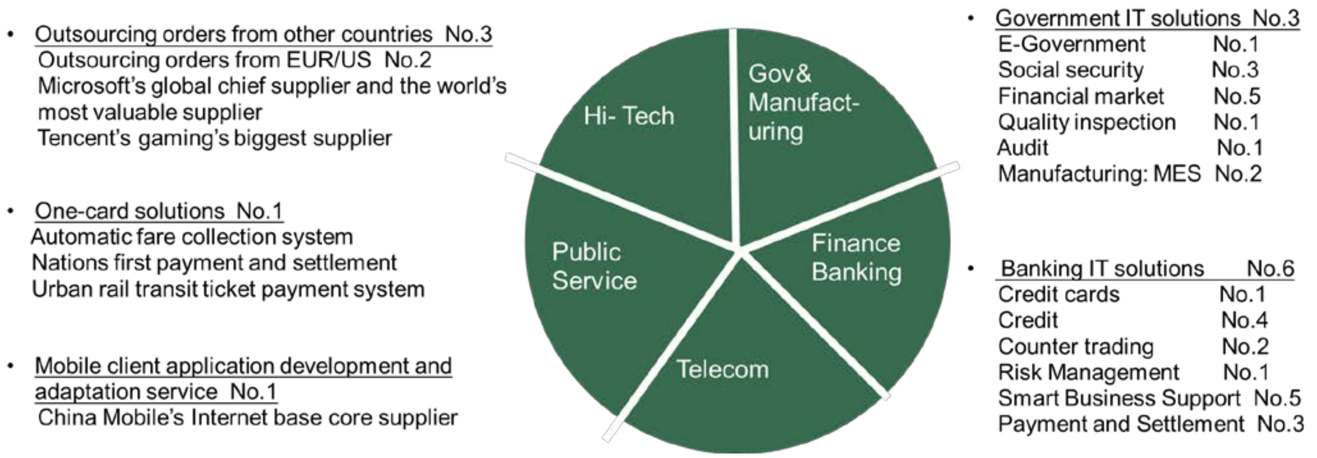
We think Chinasoft, as a leading IT outsourcing player in the domestic IT service market with numerous key clients, will benefit from the IT service digital trend. Both customer-oriented companies and large-sized B2B enterprises will have strong interest in adopting new technologies. For example, if an enterprise moves its enterprise level software, such as ERP and MES, to the cloud, it will become easier for the company to apply this software to all systems and more convenient to carry out spec migration. Notably, Chinasoft is targeting to sign a cooperative contract with local governments to support local enterprises in the industrial cluster in adopting more digital transformation, and if these enterprises are satisfied with the digital IT services, they can acquire other tailor-made services by signing other contracts with Chinasoft individually.

We believe the "share the same boat" alliance of Huawei and Chinasoft will drive it to the top of the cloud services competition. Other cloud service providers, such as Aliyun and Tencent, are internet companies who don't know much about manufacturing. Huawei, on the other side, grew as a manufacturer. We believe the combined knowledge of Huawei and Chinasoft can thus provide better total solutions to increase clients' productivity and efficiency.

Indirect competition with India's leading players

According to management, Chinasoft is the leading player in China in various markets (see Exhibit 26). Taking into consideration the business model, customer pool and focus area, we think the major competitors should be some local peers. Although overseas peers like Infosys and Tata Consultancy generally have better experience and can offer competitive quality, many of them focus more on global tier one clients and have smaller exposure to China's domestic market. Overall, we think Chinasoft can maintain its leading position in China IT services on better client relationships, expertise, and strong R&D support.

Exhibit 26: Market position by verticals (2016)

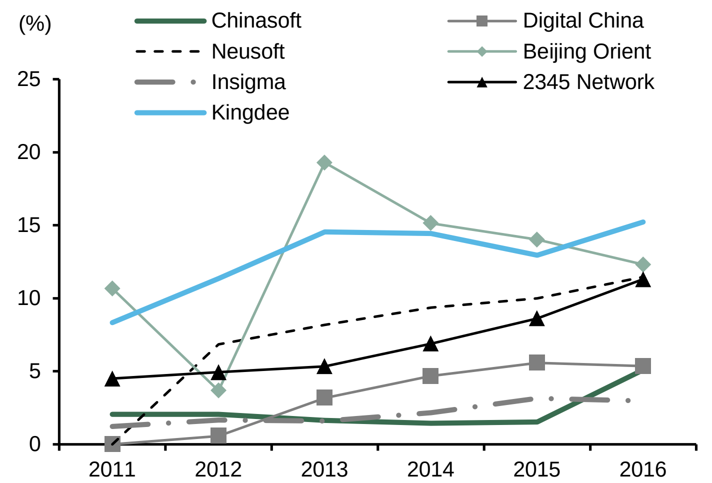


Source: Chinasoft International

Who are the local peers?

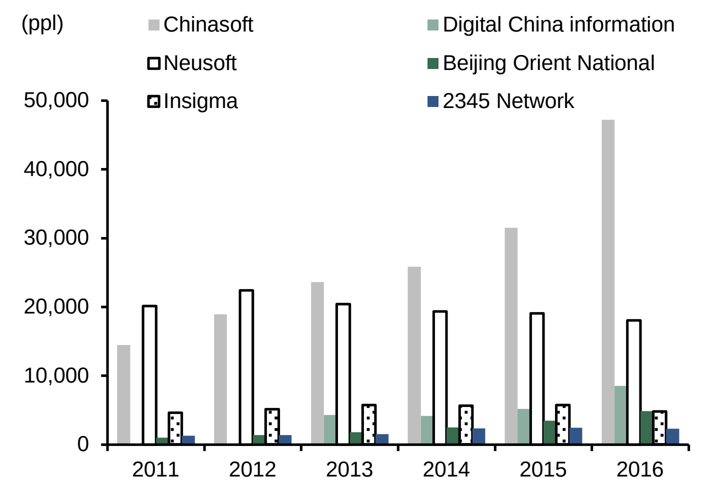
We found it is difficult to identify Chinasoft's local competitors, as different companies generally have a different focus. China's IT service market is very fragmented, as the top 10 local players only account for 16.5% of the total, based on CCID consulting data. However, we expect gradual market consolidation in the long term as we believe the quality players will stand out. Among local software peers, Chinasoft has the most employees, which also suggests strong human resource support.

Exhibit 27: R&D ratio comparison



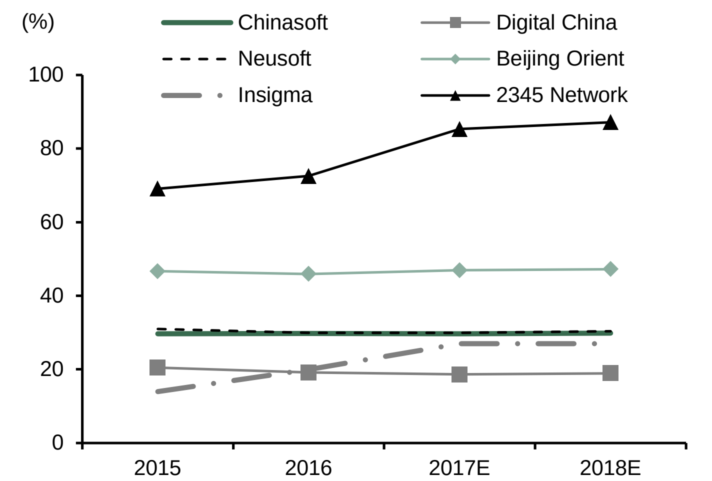
Source: Bloomberg

Exhibit 28: Total employees comparison



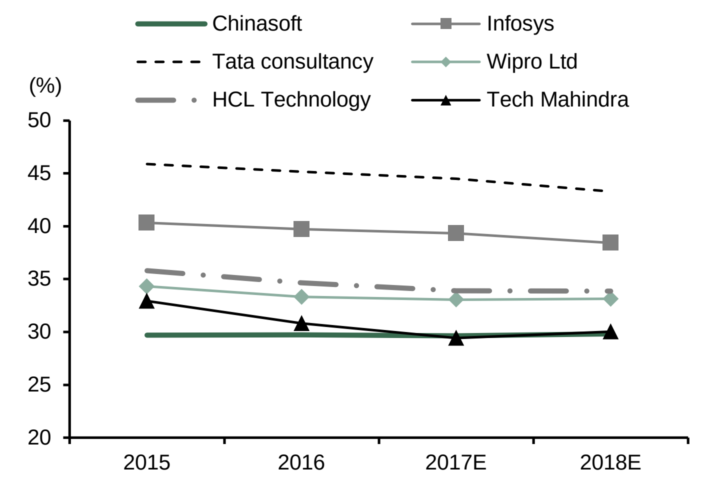
Source: Bloomberg

Exhibit 29: Gross margin comparison (Chinese players)



Sources: Bloomberg; BNP Paribas estimates

Exhibit 30: Gross margin comparison (India players)



Sources: BNP Paribas estimates

Exhibit 31: Peer comparison

Company name	BBG code	Country	Found	2016 Sales (RMB m)	Mkt. cap (RMB m)	Services capabilities	Specialised Verticals	Key Remarks
Chinasoft (中軟國際)	354 HK	China	2000	6,783	10,596	ITO, Enterprise Application development, BPO, Cloud Service and Products, Crowdsourcing platform	Hi-tech, BSFI, Manufacturing, Telecom, Public Service, Government	
Neusoft (東軟集團)	600718 CH	China	1991	7,668	15,360	Industry solutions, product engineering solutions, software products & platforms, and services	Medication, Government, Finance, Manufacturing, Mobile Internet	
Hundsun (恆生電子)	600570 CH	China	1995	2,129	30,285	Software Development and integration	BSFI, communication industry	
BeyondSoft (博彥科技)	002649 CH	China	1995	1,919	5,320	IT consulting, Application Development and Maintenance, ERP, BPO, DMAC	Hi-tech, Telecom, BSFI, Energy, Transportation	
Insigma (浙大網新)	600797 CH	China	1994	4,058	11,341	IT consulting, Application development, Cloud infrastructure, Cloud Migration and Maintenance, Big Data analytics, AI technology	Smart City, Wisdom Business	
2345 (二三四五)	002195 CH	China	1989	1,737	20,360	Industry and General Application Software and Solution Development	BSFI, Smartphone application, Logistics, Transportation	Focus on Japan market
Inspur (浪潮軟件)	600756 CH	China	1989	1,361	4,894	Cloud service, Software Outsourcing, ERP, CRM	Intelligent Government, Enterprise Cloud	
Digital China (神州信息)	000555 CH	China	1995	7,977	9,567	Application software development, special financial equipment, Big Data analytics, Cloud computing	Agricultural, BSFI, Telecom, Government and Public Sector	
Global Infotech (高偉達)	300465 CH	China	2003	968	3,747	IT solutions, IT development and maintenance and system integration	BSFI	
Beijing Orient National (東方國信)	300166 CH	China	1997	1,270	13,429	Intelligent system solutions, software development and IT technology service	Telecom	
Kingdee (金蝶國際)	268 HK	China	1993	1,862	12,142	Cloud service, Software development for accounting/ Supply Chain, Human Resources, Manufacturing purposes (ERP/CRM/MES)	Retail, Financial, Manufacturing, Shopping mall, Real Estate	No. 1 market share of ERP for SME
Sinosoft (擎天軟件)	1297 HK	China	1998	519	2,249	Tax Software, e-Government solutions, Carbon Management Solutions	e-Government	Specialised in Tax software, carbon management
Chanjet (暢捷通)	1588 HK	HK	2010	431	1,871	Software development and Cloud service	Software and Cloud service specialised in financial and management control for SME	
Kingsoft (金山軟件)	3888 HK	HK	1988	8,282	28,746	Software development on mobile internet / Gaming / Office system, and Cloud service	na.	
Infosys	INFO IN	IND	1981	60,680	247,065	Consulting, Technology, and Outsourcing Service, AI-platform, analytics platform, On-premise business platform, ERP platform	BFSI, Communication, Insurance, Manufacturing, Energy, Retail, Public Services, Healthcare	
Tata Consultancy	TCS IN	IND	1968	105,582	597,340	ITO,BPO, Consulting, System Integration, Technology services including AI, Big data, Cloud, IoT, ERP on cloud	BFSI, Communication, Insurance, Manufacturing, Energy, Retail, Public Services, Healthcare	
Accenture	ACN US	US	1989	226,434	648,847	Strategy: business, technology, operation Consulting: technology, business, management Digital: digital marketing, analytics, and mobility services Operation : ITO,BPO, Cloud service, Infrastructure	BFSI, Communication, Consumer Goods, Education, Energy, Healthcare, Manufacturing, Media, Retail, Transportation	
Cognizant	CTSH US	US	1994	89,598	287,108	IT consulting, technology services, and outsourcing services. Complex system development, Enterprise software implementation and maintenance, Data warehousing	BFSI, Communication, Consumer Goods, Education, Energy, Healthcare, Manufacturing, Media, Retail, Transportation	
Daline Hi-tech (大連華信)	832715 CH	China	1997	na	na	Application development and maintenance, System testing, ITO/BPO, Technical solutions of mobile internet, e-business, cloud computing	Intelligent Manufacturing Medical, Insurance, Telecom, Medicare	Focus on Japan market
Isoftstone (軟通動力)	Unlisted	China	2001	na	na	Business Intelligence, Enterprise application development, Consulting, Cloud computing, Mobile Computing, ERP, Digitalisation, Smart City	Technology, Communication, BFSI and Retail	Another key supplier for Huawei
Pactera (文斯海揮)	Unlisted	China	1995	na	na	Digital transformation consulting, Big data analytics, BI, Marketing Cloud, ERP, Embedded IoT application, IT outsourcing	Hi-tech, BFSI, Manufacturing, Telecom, Automotive, Medicare, Government, Retail	

Sources: Companies; BNP Paribas

Potential 2018-19 growth drivers

We divide Chinasoft's IT services business into two groups 1) legacy and 2) digital. We believe the new digital business will become the key growth driver in FY18-19. The digital business mainly includes 1) JointForce, 2) Big data analytics, and 3) Cloud services and products. We forecast legacy business revenue to see a 13.1% CAGR over FY18-19E, while digital business grows 39.9% over the same period.

Exhibit 32: Our assumptions on revenue and margin (2017-18E)

(%)	--- Sales growth (y-y) ----		----- Gross margin ---		
	2017E	2018E	2017E	2018E	Company guidance
TPG	**33**	**19**	**25.2**	**25.9**	
TPG-Legacy	30	15	23.8	24.2	Company guided legacy business growth will be stronger than that of the China IT service market of c10%.
TPG-Big data	55	33	41.0	40.1	Company guided to 40-50% growth in FY18
TPG-Cloud Service	100	90	39.0	37.5	Company guided cloud service revenue will double y-y in FY18
IIG	**34**	**31**	**48.6**	**44.9**	
IIG (excluding JF)	23	19	58.2	57.2	c37%China cloud services CAGR in FY16-21, according to Gartner. Company also confident it will see cloud take-up growing at a high speed
JointForce	192	100	15.4	15	Company guided that JointForce revenue will double y-y in FY18

Sources: Chinasoft; BNP Paribas estimates

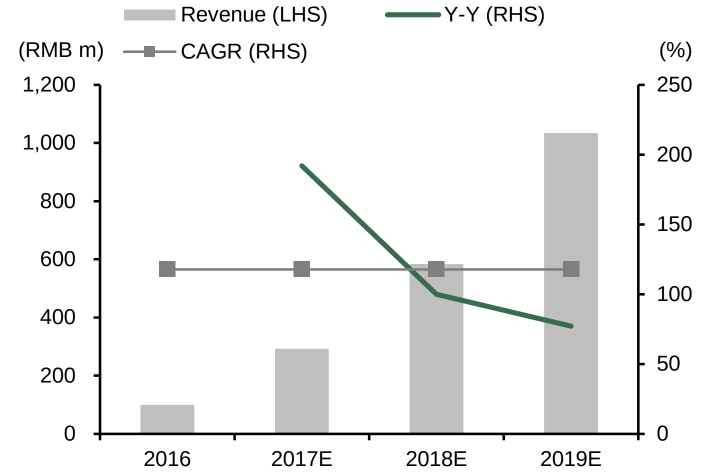
New opportunity from JointForce platform

JointForce is a trusted IT service crowdsourcing platform based on social collaboration and the sharing economy. It provides a transaction and communication platform for customers with short- or medium-term IT service needs on which they can contact individuals, teams and enterprises who provide such services. To enable both transacting parties to complete the customised development and delivery of software in a rapid, safe and effective manner, it provides the Development Collaboration Cloud, effective and comprehensive assistance, and guidance throughout IT services. Currently, JointForce has 180,000 engineers and 20,000 companies posting projects amounting to over RMB800m, based on 1H17 data.

On 29 July 2017, JointForce upgraded to a second version and launched new one-stop software development cloud services for developers by further cooperating with Huawei. In addition to the cooperation, Chinasoft carried out new software engineering services, “Cloud Software Park”, designed to customise solutions for software companies in Software Park by leveraging JointForce as an “entrance,” Huawei development cloud as a platform, and Chinasoft's application development capabilities as the content. “Cloud Software Park” has been conducted in Qingdao, Xi'an, Nanjing and Xuzhou, and the company aims to link 300 key software parks in China in next 5-10 years, according to management. Notably, Chinasoft plans to establish nationwide offline operation centres in 18 different cities to support online ad-hoc projects from the long-tailed market and the company's business strategies, such as “Cloud Software Park.” These centres will allow JointForce to scale up its revenue and create an online and offline ecosystem to support China's government in achieving its goal of smart cities.

We forecast JointForce revenue will expand to RMB1,034m in FY19E from RMB100m in FY15, a CAGR of 118% over FY16-19E, driven by 1) JointForce's first-mover advantage, 2) the “share the same boat” strategy with Huawei Cloud and 3) continuous expansion of Cloud Software Park. In this sector, we see limited competition and believe ZBJ (豬八戒) and Kuai mai (快碼) are key competitors only in the crowdsourcing platform. However, management indicated JointForce's competitive edge is based on Chinasoft's IT know-how. The company can verify the suppliers' quality on the platform and check their ability to deliver the IT services in time, while competitor platforms cannot provide the same services.

Exhibit 33: JointForce revenue and growth assumption



Sources: Chinasoft International; BNP Paribas estimates

Exhibit 34: JointForce online platform

Sources: Chinasoft International

Big Data centre management demand driven by data analytics trend

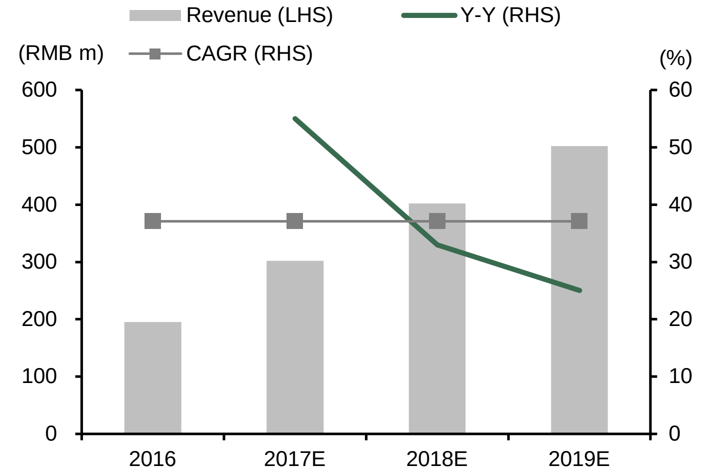
IDC forecasts big data and the analytic market will grow from USD130b to USD203b in revenue from 2016 to 2020, an 11.8% CAGR. We have highlighted the significant potential opportunities in the China internet market driven by e-commerce and mobile applications. To win market share in the new business model, enterprises will need to develop analytics to extract value-added concepts from billions of bytes data, which will in turn drive demand for data analytics and infrastructure to manage this data. As such, we forecast the big data-related business (classified as TPG business) will see a 37% CAGR over FY16-19 and sales expand to RMB502m in FY19 from RMB195m in FY16.

Exhibit 35: Case study of big data implementation from Chinasoft clients

Counterparty	Time	Description
Ampang Group	2016	Chinasoft focuses on big data management and business innovation in financial institutions Won the bid for distributed data platform construction project for Ampang group
Gold wind (002202 CH, NR)	2016	Chinasoft won the Gold Wind technology digital management project Penetrated into large-scale equipment manufacturing and energy industry through big data capabilities
Xinhua News Agency	1H17	Providing data asset management consulting serviced to Xinhua News Agency China Economic Information Service Assisting customer to build economic data standard system to explore the comprehensive data
PetroChina (PTR US, NR)	1H17	Won the bid for Petro China big data project Establishing a platform for the customer to achieve historical and real-time data storage, processing, and sharing with regional companies
China West Airport Group	1H17	Arranging planning and implementation services for the first phase of data canter construction project Chinasoft aims to help the customer strengthen data management, and promote smart management operation to achieve the goal of a smart airport

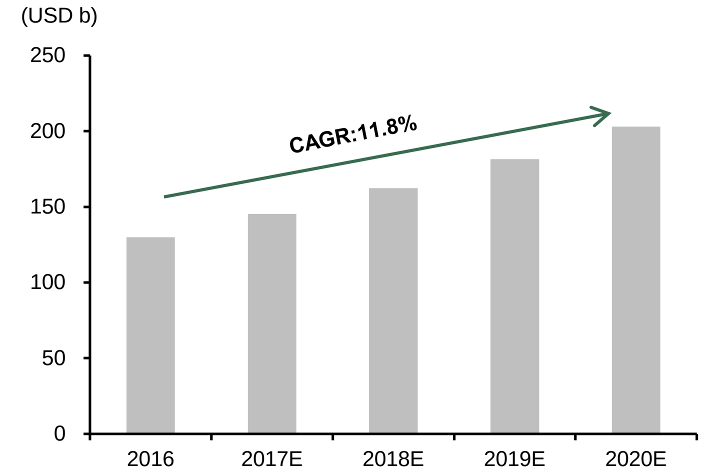
Source: Chinasoft International

Exhibit 36: Big data-related revenue and growth assumption



Sources: Chinasoft International; BNP Paribas estimates

Exhibit 37: Big data and analytic market revenues



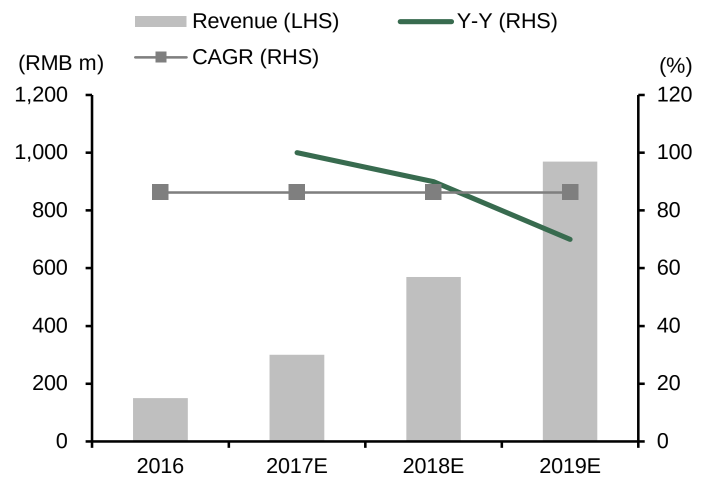
Source: IDC

Stronger demand for cloud service

We see strong demand for cloud service over the next few years, driven by 1) rising enterprise cloud adoption, and 2) upgrades of analytic abilities, which can be done on the cloud at a cost advantage to traditional analytics. We discuss cloud business as two segments: 1) services and 2) products, in line with the current service classification from Chinasoft.

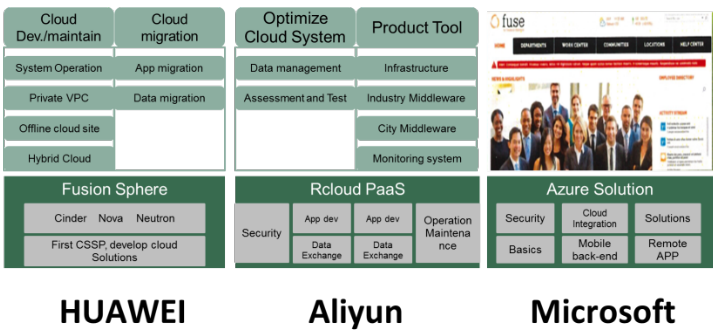
Cloud services mainly focus on cloud migration, helping customers migrate their data to the cloud, and consulting services, helping clients figure out which kinds of cloud services will suit their company best. Chinasoft came up with a total solution called Cloud Manager (雲管家), by providing clients with consulting, migration, management and other professional cloud services. Surprisingly, cloud services are currently categorised in TPG. As such, we factor in a new item in TPG to distinguish the faster growth rate of cloud services from legacy business. We forecast the revenue from cloud services at RMB300m in FY17, expanding to RMB969m in 2019, at a CAGR of 86% in 2016-19E.

Exhibit 38: Cloud services revenue and growth assumption



Sources: Chinasoft; BNP Paribas estimate

Exhibit 39: Cloud services with different severs provider



Sources: Chinasoft; BNP Paribas

Cloud Services can be divided into three types based on the degree of user involvement, including Infrastructure-as-a-Service (IaaS), Platform-as-a-Service (PaaS), and Software-as-a-solution (SaaS). If a user only uses the cloud server from the cloud services vendor and manages the middleware and application by themselves, the services are classified as IaaS. Chinasoft plays a role as IT service player, so it will only focus on the middleware and the application development, and cooperate with server infrastructure providers such as Huawei, Aliyun and Microsoft. Chinasoft has partnered with key players in this area since 2013 and reached strategic cooperation with Huawei Software Development Cloud and Tencent Cloud.

We believe this first-mover advantage in collaborating with key players in the cloud space will lift Chinasoft's core ITS competence by leveraging previous experience and tying it to that of major server vendors to grow under the megatrend of cloud development.

Exhibit 40: Cloud sever counterparties in cooperation with Chinasoft

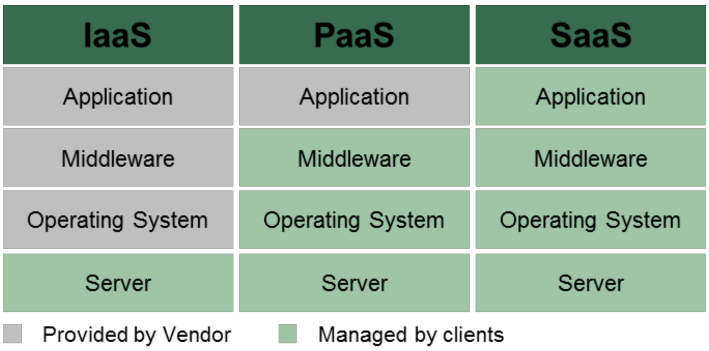
Counterparty	Description
Aliyun	Chinasoft integrated its middleware, ResourceOne, into Aliyun's cloud's PaaS (Platform as a Solution) layer, used by government entities. Notably, Chinasoft is developing middleware to construct the ecosystem for a smart city based on Alibaba's City Cloud
Microsoft	In 2014, Chinasoft purchased Catapult Systems, a consulting service provider specialised in Microsoft cloud service, and developed the enterprise cloud portal called "Fuse" based on Azure, a public cloud from Microsoft
Huawei	Chinasoft signed the strategic contract with Huawei in 2016 and determined to work with Huawei as strategic partners and leverage its core capabilities and ecosystem to devote to cloud migration, smart city operation, software cloud and, smart manufacturing cloud.
Tencent	In 2016, Chinasoft signed a strategic agreement with Tencent and became one of the channel partners of Tencent Cloud

Source: Chinasoft International

We consider the middleware and application development on the cloud sever as cloud products, which are classified in the IIG business by Chinasoft. We believe Chinasoft will transform application development and maintenance services into a cloud product, which are implemented on the cloud. The middleware of "Fuse," based on Microsoft Azure cloud, invented by Catapult, can be included under cloud products as well. Catapult will account for approximately RMB300m in revenue in FY17E, based on management guidance. Recently, Chinasoft and Huawei announced a "smart manufacturing" solution, which was implemented in Guangdong and Jiangsu. The project includes signing a contract with the local government to provide an analysis platform as a service based on the Huawei cloud for local manufacturing enterprises to adopt the digital technology, helping the government achieve the goal of intelligent manufacturing under the "Made in China 2025" policy.

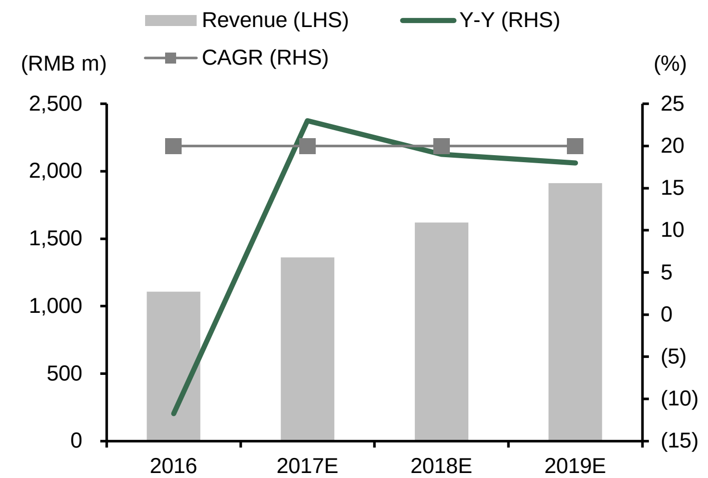
Within the IIG business, the 1) middleware and applications development from PaaS and SaaS services 2) Catapult, and 3) Smart manufacturing solutions, all possess internet and cloud product's characteristics. Therefore, we exclude JointForce and create a new item "IIG (excluding JointForce)" to measure the growth rate of cloud products into our model. We forecast IIG (excluding JointForce) revenue will grow to RMB1,913m in FY19 from RMB1,107m in FY16, a CAGR of 20%.

Exhibit 41: Service models from cloud service providers



Sources: NIST

Exhibit 42: IIG (excluding JF) revenue and growth assumption



Sources: Chinasoft International; BNP Paribas estimates

ROE analysis

We use a DuPont analysis to evaluate the level of ROE Chinasoft could generate from its business model, and compare this with the consensus estimated returns of major peers. Our assessment suggests that Chinasoft is generating slightly better returns than domestic players, based on its higher asset turnover rate and leverage ratio. Management believes the net margin can continue to increase due to rising operating leverage. As such, we are confident of its ROE expansion prospects.

Exhibit 43: DuPont analysis comparison

Company name	BBG code	----------- Net margin -----------			---------- Asset turnover ----------			---------- Leverage ratio --------			---------------- ROE ---------------		
		2016	2017E	2018E	2016	2017E	2018E	2016	2017E	2018E	2016	2017E	2018E
		(%)	(%)	(%)	(x)	(x)	(x)	(x)	(x)	(x)	(%)	(%)	(%)
Chinasoft	354 HK	6.5	6.3	6.8	1.0	1.2	1.3	1.8	1.6	1.6	11.8	12.5	14.5
Digital China	000555 CH	3.0	3.4	3.9	0.9	0.9	0.9	2.1	1.9	1.8	6.2	5.9	6.8
Neusoft	600718 CH	5.0	6.2	6.7	0.6	0.6	0.7	1.8	1.6	1.6	5.6	5.7	7.2
Beijing Orient I	300166 CH	25.8	26.0	26.1	0.3	0.3	0.4	1.3	1.2	1.2	11.3	10.2	12.1
Insigma	600797 CH	6.0	11.6	9.8	0.9	0.9	0.9	2.0	1.2	1.3	11.0	12.3	11.6
2345 Network	002195 CH	36.6	40.8	40.5	0.3	0.3	0.4	1.1	1.1	1.1	11.5	13.0	15.0
Kingdee	268 HK	15.5	10.5	11.8	0.3	0.4	0.5	1.7	1.5	1.4	8.6	6.4	7.9

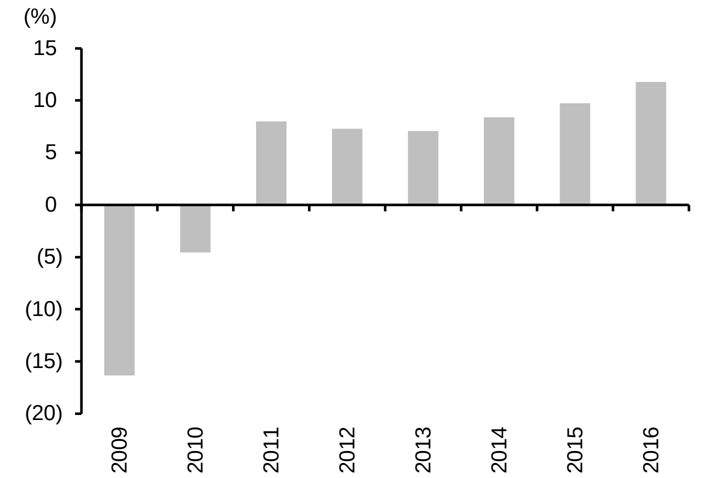
Sources: Company data; Bloomberg Consensus; BNP Paribas estimates for Chinasoft

Net profit margin – We don't think this is a clear driver of ROE expansion, as the IT services market is so fragmented that the bargaining power remains with the customer. Also, the overall ASP in the Chinese IT outsourcing market is much lower than that in other markets. However, we forecast Chinasoft's net margin will expand to 6.8% in FY18 from 6.5% in FY16, mainly driven by operating leverage.

Financial leverage – Chinasoft ranks among the top of the companies included in this comparison on this measure. Notably, we believe the high asset utilisation rate can indicate the company performed well on maximising returns on available assets.

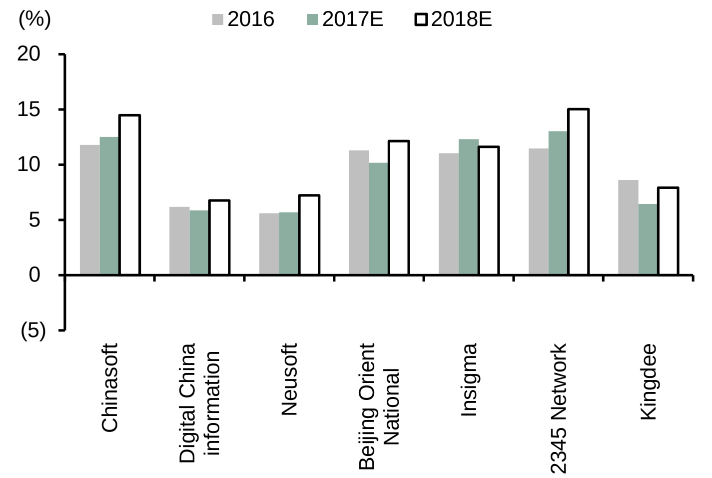
Leverage ratio – This is not an important factor for Chinasoft to expand ROE. Chinasoft's leverage ratio (total asset/total equity) has been declining in line with the company's strategy to offer higher value-added services without asset expansion. Notably, the company ranks in the middle among all the companies we analysed.

Exhibit 44: Historical ROE trend



Sources: Chinasoft International

Exhibit 45: ROE comparison



Sources: Company data; Bloomberg consensus; BNP Paribas estimates (for Chinasoft)

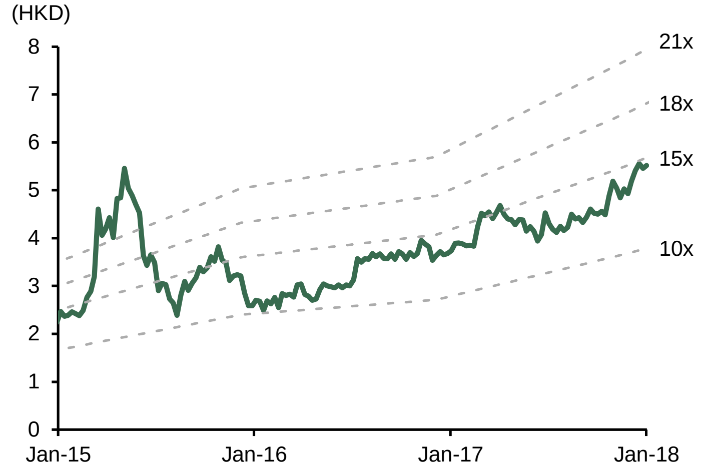
Valuation

Initiate coverage at BUY with a target price of HKD6.70

We initiate coverage of Chinasoft with a BUY rating and TP of HKD6.70, implying 23% potential upside. Our TP of HKD6.70 is set at 17x FY18E PE, in line with HK peers' avg at c18x (more conservative than global peers' 19x). The current 14.1x FY18E P/E does not look demanding compared with the historical five-year average of 16x and standard deviation at 3.1x. We think the stock deserves to rerate given our expectation of steady earnings growth with continued ROE expansion to 16.3% in FY19E. On the back of strong cloud services demand and the China IT outsourcing market's steady growth, we expect the company to grow its revenue and earnings by 21%/20% and 32%/30%, respectively, in FY18-19E.

Downside risks to our call include: 1) ASP erosion from market competition; 2) worse-than-expected cloud services demand; 3) worsening overall macro environment; 4) market share loss at key clients; and 5) labour cost hike and decline in talent retention.

Exhibit 46: 12M forward P/E bands

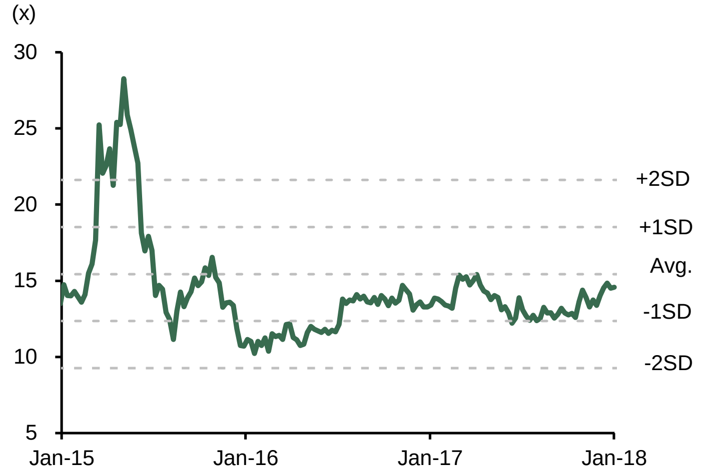


Sources: Bloomberg; BNP Paribas estimates

Exhibit 47: 12M forward P/BV bands

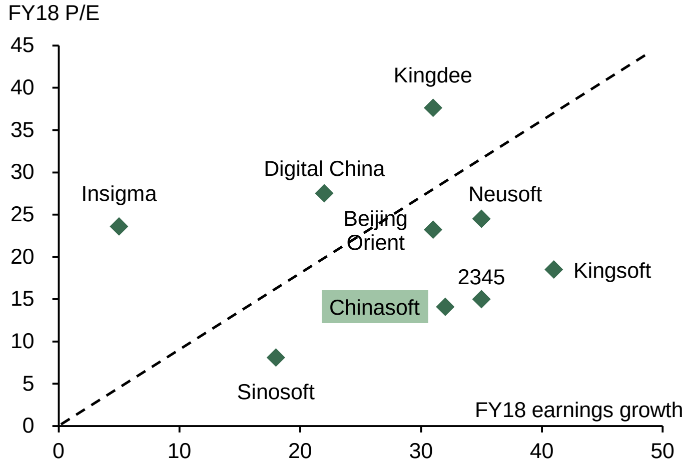
Sources: Bloomberg; BNP Paribas estimates

Exhibit 48: Historical 12M forward P/E bands



Sources: Bloomberg; BNP Paribas estimates

Exhibit 49: FY18E earnings growth vs P/E



Sources: Bloomberg; BNP Paribas estimates

Exhibit 50: Valuation comparison

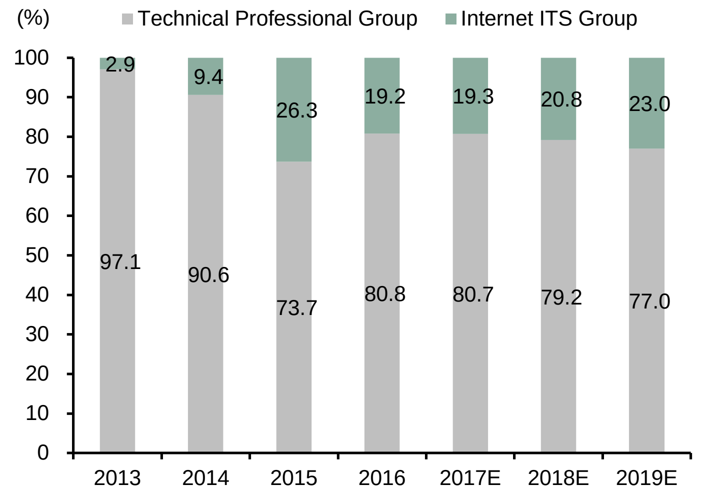
Name	BBG code	CCY	Price	Mkt cap	Earning growth		-------- EPS --------		------- P/E -------		------- P/BV -------		------- ROE -------		-- Sales growth --	
					2017E	2018E	2017E	2018E	2017E	2018E	2017E	2018E	2017E	2018E	2017E	2018E
			(LC)	(USD m)	(%)	(%)	(LC)	(LC)	(x)	(x)	(x)	(x)	(%)	(%)	(%)	(%)
HK listed																
Chinasoft	1571 HK	HKD	5.45	1,674	16	32	0.24	0.31	18.6	14.1	2.2	1.9	12.5	14.5	33	21
Kingdee	268 HK	HKD	5.00	1,925	27	31	0.08	0.11	49.7	37.6	3.1	2.9	6.8	7.8	21	20
Sinosoft	1297 HK	HKD	2.25	356	19	18	0.19	0.22	9.6	8.1	2.1	1.8	21.5	22.4	19	17
Chanjet	1588 HK	HKD	10.72	298	n.m.	(8)	0.72	0.66	12.1	13.1	1.9	1.8	17.0	15.0	40	27
Kingsoft	3888 HK	HKD	26.90	4,575	34	41	1.02	1.17	21.2	18.5	2.8	2.5	11.8	13.2	(35)	39
Average Hong-Kong peers					**27**	**23**			**22.2**	**18.3**	**2.4**	**2.2**	**13.9**	**14.6**	**15**	**25**
China listed																
Digital China	000555 CH	RMB	9.90	1,496	(18)	22	0.30	0.36	33.0	27.5	2.0	1.8	5.9	6.8	7	6
Neusoft	600718 CH	RMB	12.52	2,392	(75)	35	0.37	0.51	33.6	24.5	1.9	1.8	5.7	7.6	(24)	21
Beijing Orient	300166 CH	RMB	12.45	2,135	25	31	0.41	0.54	30.2	23.2	2.9	2.6	9.9	11.6	30	31
Insigma	600797 CH	RMB	10.64	1,778	49	5	0.43	0.45	24.7	23.6	2.9	2.6	12.3	11.6	1	25
2345 Network	002195 CH	RMB	5.90	3,207	69	35	0.29	0.39	20.1	15.0	2.4	2.1	13.0	15.0	25	35
Average A-share peers					**10**	**26**			**28.3**	**22.8**	**2.4**	**2.2**	**9.4**	**10.5**	**8**	**24**
Global																
Infosys	INFO IN	IND	1,144.6	38,580	6	12	62.72	70.90	18.2	16.1	3.8	4.3	22.0	22.7	10	3
Tata consultancy	TCS IN	IND	3,138.6	94,337	9	(2)	133.42	133.32	23.5	23.5	7.0	7.6	32.6	30.6	9	4
Wipro Ltd	WPRO IN	IND	300.8	21,006	(5)	(4)	17.56	17.23	17.1	17.5	2.8	3.0	17.2	17.2	7	(1)
HCL Technology	HCLT IN	IND	984.9	21,540	52	3	59.92	62.29	16.4	15.8	4.2	3.8	27.5	25.2	50	8
Tech Mahindra	TECHM IN	IND	611.1	9,385	(7)	25	32.04	40.87	19.1	15.0	3.3	3.0	18.3	20.9	10	5
Accenture PLC	ACN US	USD	160.7	103,274	9	11	5.90	6.66	27.2	24.1	12.0	9.9	46.0	44.5	6	10
Cognizant	CTSH US	USD	78.0	45,698	7	14	3.72	4.35	21.0	17.9	4.2	3.7	18.4	19.4	10	9
Average global peers					**10**	**8**			**20.4**	**18.6**	**5.3**	**5.1**	**26.0**	**25.8**	**14**	**5**

Priced as of 1 Feb 2018 close, 31 Jan 2018 for US and India stocks
Sources: *BNP Paribas estimates; all others (Not rated) are Bloomberg consensus estimates

Financial analysis

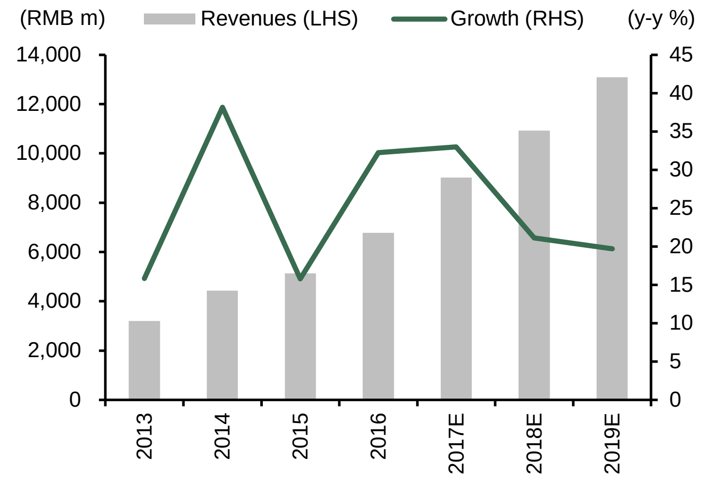
There was a clear upward trend in Chinasoft's sales from 2013 to 2016, with a compound annual growth rate of 28.4%. 2016 net profit came in at RMB442m, up 58% y-y. FY16 revenue was RMB6,783m, up 32% y-y, mainly driven by its largest client enlarging its cooperation in cloud solutions. We expect sales to grow by 33%, 21%, and 20% y-y in FY17-19, with the share of Internet ITS services rising to 23% in FY19, from 19% in FY16.

Exhibit 51: Revenue mix by product



Source: Chinasoft; BNP Paribas estimates

Exhibit 52: Revenues and y-y growth

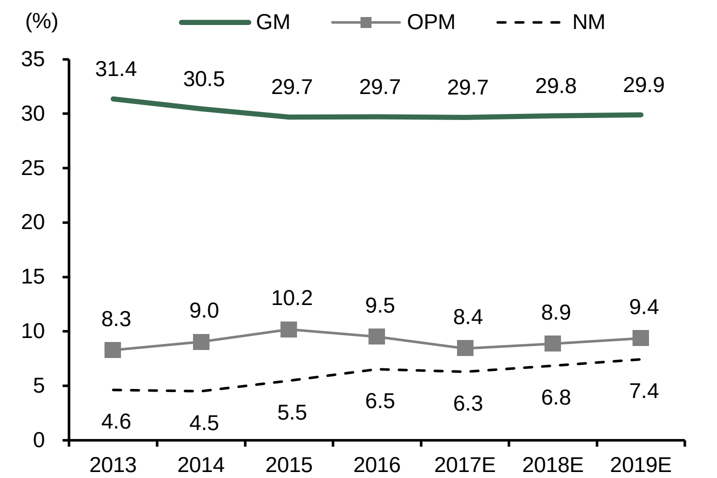


Source: Chinasoft; BNP Paribas estimates

Profitability and margins

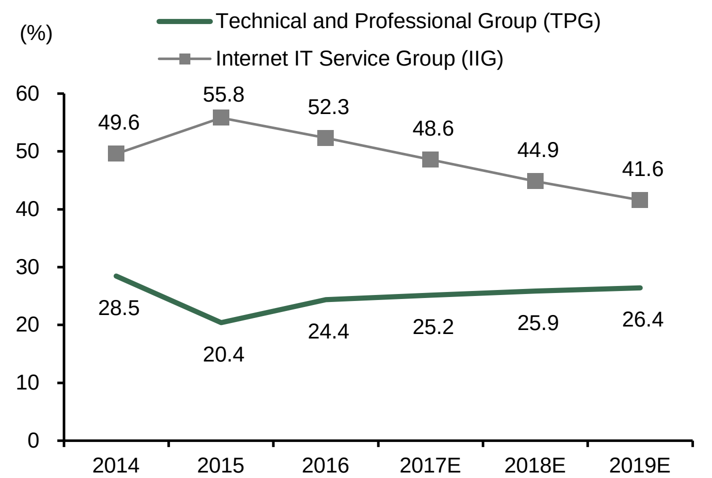
Chinasoft saw a stable gross margin over 2014-16 of around 30%. We think its margin performance will remain stable, supported by a favourable product mix with a higher contribution from new business, such as big data, cloud services and products. We believe the opex ratio will decrease in 2017-18, due to control of operating expenses and better revenue scale. As such, we forecast a net margin at c6-7% in FY17-19.

Exhibit 53: Margin profile



Source: Chinasoft; BNP Paribas estimates

Exhibit 54: GM comparison: TPG vs IIG



Source: Chinasoft; BNP Paribas estimates

Exhibit 55: Quarterly P&L

	1H15 (RMB m)	2H15 (RMB m)	1H16 (RMB m)	2H16 (RMB m)	1H17 (RMB m)	2H17E (RMB m)	1H18E (RMB m)	2H18E (RMB m)	1H19E (RMB m)	2H19E (RMB m)	2015 (RMB m)	2016 (RMB m)	2017E (RMB m)	2018E (RMB m)	2019E (RMB m)
Sales	2,389	2,740	2,885	3,898	4,145	4,876	4,665	6,263	5,694	7,390	5,129	6,783	9,021	10,929	13,084
Gross profit	677	846	803	1,213	1,143	1,532	1,367	1,891	1,683	2,229	1,523	2,016	2,675	3,258	3,912
Operating profit	227	295	300	345	336	425	537	432	749	477	522	645	761	969	1,227
Pre-tax profit	154	266	266	258	268	357	477	372	689	417	420	525	625	849	1,107
Net income	140	140	236	206	245	322	420	327	606	367	280	442	567	747	974
EPS	0.07	0.07	0.11	0.09	0.10	0.13	0.17	0.14	0.25	0.15	0.14	0.20	0.24	0.31	0.41
Margins (%)															
Gross margin	28	31	28	31	28	31	29	30	30	30	29.7	29.7	29.7	29.8	29.9
Operating margin	10	11	10	9	8	9	12	7	13	6	10.2	9.5	8.4	8.9	9.4
Pre-tax margin	6	10	9	7	6	7	10	6	12	6	8.2	7.7	6.9	7.8	8.5
Net margin	6	5	8	5	6	7	9	5	11	5	5.5	6.5	6.3	6.8	7.4
Change (h-h %)															
Sales		*15*	*5*	*35*	*6*	*18*	*(4)*	*34*	*(9)*	*30*					
Gross profit		*25*	*(5)*	*51*	*(6)*	*34*	*(11)*	*38*	*(11)*	*32*					
Operating profit		*30*	*2*	*15*	*(3)*	*27*	*26*	*(20)*	*74*	*(36)*					
Pre-tax profit		*72*	*0*	*(3)*	*4*	*33*	*33*	*(22)*	*85*	*(39)*					
Net income		*1*	*68*	*(13)*	*19*	*31*	*31*	*(22)*	*85*	*(39)*					
Change (y-y %)															
Sales			*21*	*42*	*44*	*25*	*13*	*28*	*22*	*18*		*32*	*33*	*21*	*20*
Gross profit			*19*	*43*	*42*	*26*	*20*	*23*	*23*	*18*		*32*	*33*	*22*	*20*
Operating profit			*32*	*17*	*12*	*23*	*60*	*1*	*39*	*11*		*24*	*18*	*27*	*27*
Pre-tax profit			*72*	*(3)*	*1*	*38*	*78*	*4*	*44*	*12*		*25*	*19*	*36*	*30*
Net income			*69*	*47*	*4*	*56*	*71*	*2*	*44*	*12*		*58*	*28*	*32*	*30*

Sources: Chinasoft; BNP Paribas estimates

Exhibit 56: Earnings comparison vs consensus

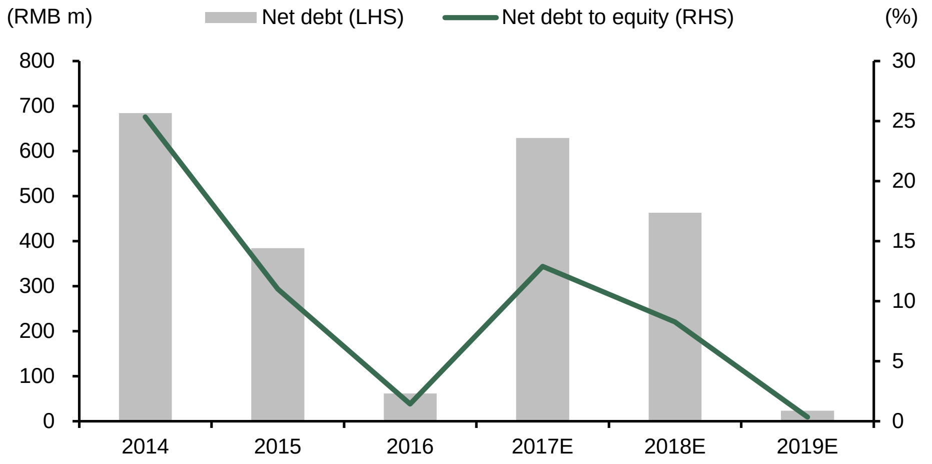
	---------------------- 2017E ----------------------			---------------------- 2018E ----------------------			---------------------- 2019E ----------------------		
	BNPP (RMB m)	Cons (RMB m)	*Change* (%)	BNPP (RMB m)	Cons (RMB m)	*Change* (%)	BNPP (RMB m)	Cons (RMB m)	*Change* (%)
Sales	9,021	8,875	*2*	10,929	10,831	*1*	13,084	13,007	*1*
Gross profit	2,675	2,608	*3*	3,258	3,183	*2*	3,912	3,809	*3*
Operating profit	761	720	*6*	969	931	*4*	1,227	1,162	*6*
Pre-tax profit	625	635	*(1)*	849	846	*0*	1,107	1,099	*1*
Net profit	567	578	*(2)*	747	735	*2*	974	939	*4*
Margin (%)									
Gross margin	29.7	29.4		29.8	29.4		29.9	29.3	
Operating margin	8.4	8.1		8.9	8.6		9.4	8.9	
Pre-tax margin	6.9	7.2		7.8	7.8		8.5	8.4	
Net margin	6.3	6.5		6.8	6.8		7.4	7.2	

Source: Bloomberg consensus; BNP Paribas estimates

Healthy balance sheet

We are not concerned about Chinasoft's balance sheet. Its net debt to equity ratio continued to improve thanks to stable cash inflow and lower debt in FY14-16. However, we estimate the net debt to equity ratio jumped to 13% in FY17, from 1% in FY16, due to a higher working capital requirement. The balance sheet should recover from FY2018 as management believes AR can fall 10-20 days per annum. We forecast free cash flow will also turn positive in FY18 due to a lower working capital requirement.

Exhibit 57: Net debt and net debt to equity ratio

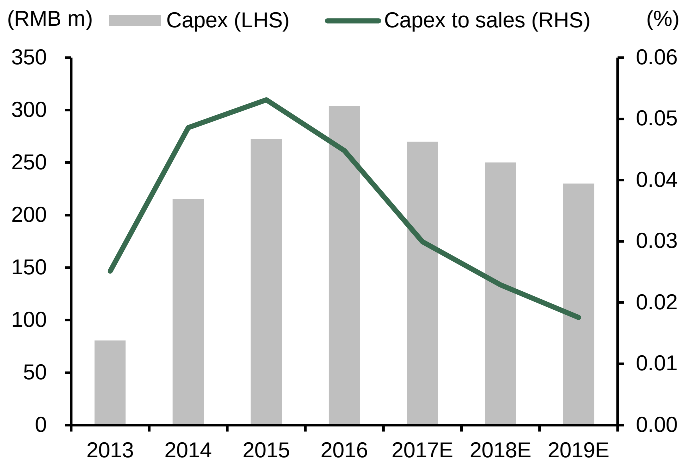


Sources: Chinasoft; BNP Paribas estimates

Cash flow performance deteriorate in FY17E, but is improving gradually

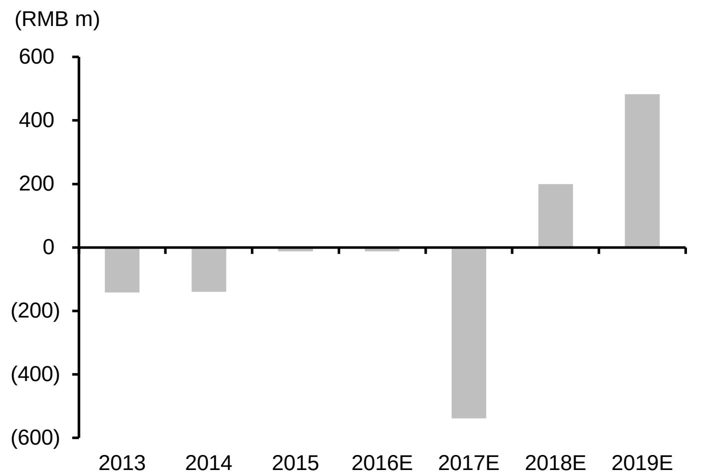
Our model factors in 2017E and 2018E capex of RMB270m and RMB250m, based on management guidance. We expect capex to decline to RMB230m in FY19. Management expects to maintain a minimum c5-6% cash dividend pay-out ratio, which suggests a cash dividend yield of c0.3% in FY16 based on the current stock price and our estimates. Notably, FY16 was the first year the company paid out a dividend since 2008.

Exhibit 58: Capex and capex to sales



Sources: Chinasoft; BNP Paribas estimates

Exhibit 59: FCF performance



Sources: Chinasoft; BNP Paribas estimates

Risk to our call

Market share loss at key customer and client base concentration risk

Huawei accounted for 59% of total Chinasoft sales in 1H17. Potential market share losses at Huawei are therefore a risk to our earnings forecasts for Chinasoft, as is client concentration risk if Huawei were to account for a growing proportion of Chinasoft sales.

Worse-than-expected Cloud services and product growth in the digital era

Worse-than-expected China Cloud services and products, such as big data analytics, cloud migration services and SaaS / PaaS, would have a strong negative impact on our forecast sales and earnings.

Higher competition in IT services crowdsourcing platform

We think Chinasoft has better IT services capability to run the crowdsourcing platform, compared with current competitor. However, we don't rule out the possibility that other leading IT outsourcing vendors will penetrate crowdsourcing platforms and increase the competition for JointForce in the future.

ASP erosion from market competition

Although we don't expect to see significant price erosion in the next few years, as Chinasoft showcased its ability to maintain its gross margin at 30% for many years and we forecast the higher margin service contribution will continue to rise in the future, we can't rule out the possibility that market competition will result in margin pressure. We might see new players expanding into verticals in which Chinasoft specialises.

Labour cost hike and talents retention ability

Chinasoft might face a programmer wage hike of 5-7% per annum, according to management, and has previously encountered difficulties in passing on labour cost increases. Besides, Chinasoft may find it difficult to retain skilled engineers as demand increases globally.

Worsening macro environment

A slow macro environment or uncertain outlook in China could lead to a more conservative client base, with potential downside to Chinasoft's profitability if enterprises decide not to invest in IT migration in the digital era, dragging down the overall IT services market.

Market share loss to international competitors

Chinasoft has accelerated its global expansion, and plans to establish new centres to trace its biggest client's business expansion worldwide, leveraging the megatrend of "One belt, One Road". As such, we believe the IT services offered by Chinasoft have been accepted by foreign countries. However, international players, such as Infosys and Tata Consultancy, also have strong global footprints. We can't rule out the possibility that customers adopt competitor services and solutions in overseas markets.

Company profile

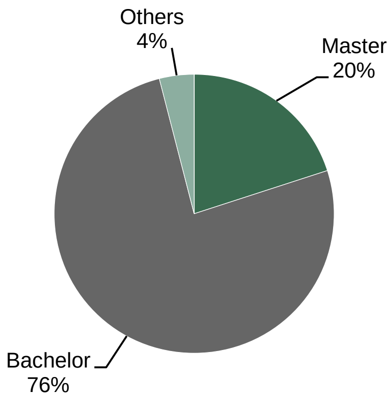
Listed in 2004, Chinasoft International is a leading IT outsourcing services provider in the Chinese market. With many years of accumulated know-how across verticals, Chinasoft has developed an end-to-end business model that integrates IT consulting, solutions, outsourcing and training services. It is also actively engaged with key industries, such as manufacturing, government, public services, high- tech, finance, and telecom. In terms of client base, Chinasoft has built a strong partnership with global blue-chip companies, including Microsoft, HSBC, Huawei and Alibaba. For the next step, Chinasoft aspires to achieving RMB10b in sales from IT outsourcing services, cloud solutions, and JointForce in five years by leveraging its cloud-based digital transformation services.

Exhibit 60: Key milestones- Chinasoft International

Time	Key event
2000	Established Chinasoft International Ltd.
2000	Introduced proprietary application support platform ResourceOne V1.0
2004	Listed with ticker of 8216 HK on the growth enterprise market of HKSE
2004	Entered IT training field through acquisition of Computer Training Centre of CS&S
2005	Acquired Chinasoft Cyber Resource Software Technology (Tianjin) Co. Ltd to enhance the field of ITO
2005	Absorbed strategic investments from Microsoft, IFC and JP Morgan
2008	Listed with ticker of 354 HK on the Hong Kong Stock Exchange
2008	Became IBM's top SOA cooperative partner to jointly establish the Chinasoft SOA innovation centre.
2009	Became the first Microsoft Premier Vendor in China
2010	Achieved market share ranked No.3 in Huawei-specific services
2010	Entered into the field of mobile Internet by acquisition of MMIM Technologies Co. Ltd.
2010	Acquired Han Consulting (China) Ltd, strengthening company's consulting capabilities
2012	Signed strategic cooperation agreement with Ali Cloud to jointly develop PaaS platform
2012	Partnered with Huawei and launched a JV, Chinasoft International Technology Services Co., Ltd.
2013	Purchased Catapult Systems, an consulting service provider specialised in Microsoft Business
2014	Implements the enterprise transformation via the JointForce platform
2014	Signed the cooperation agreement with Tencent as the largest supplier of Tencent Games service
2015	Catapult Systems developed the enterprise cloud portal called “Fuse” based on Microsoft Azure
2015	Divided into IIG(Internet ITS Group) and TPG (Technology Professional Group)
2016	Signed strategic agreement with Tencent Cloud
2016	Became a channel partner of Jingdong Cloud

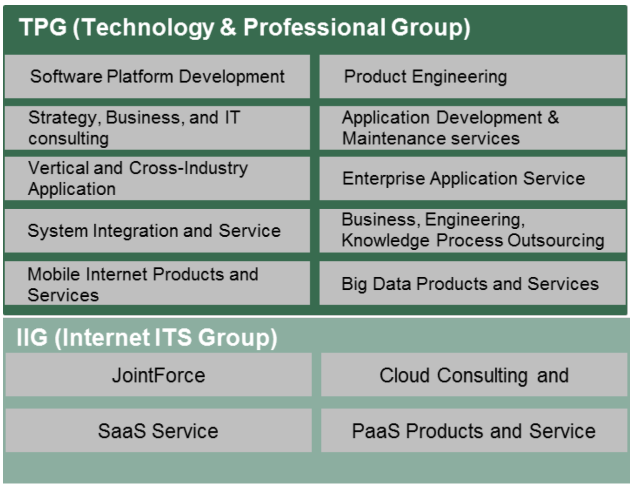
Sources: Chinasoft International

Exhibit 61: Employee mix by education



Source: Chinasoft International

Exhibit 62: Chinasoft Business division



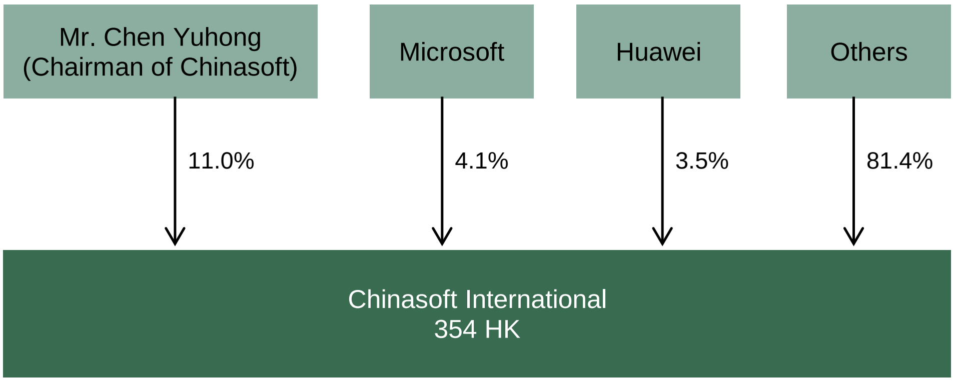
Source: Chinasoft International

Exhibit 63: Top 10 shareholders

Major shareholder name	Holding (%)
YuHong Chen	11.0
UBS	6.5
JP Morgan	4.8
Microsoft	4.1
Huawei	3.5
Franklin Resources	3.1
Vanguard Group	2.5
Harvest Fund Management	1.7
Dimensional Fund Advisors LP	1.1
Blackrock	0.9
Others	66.9

Source: Bloomberg; Chinasoft Annual Report (2016)

Exhibit 64: Shareholder structure



Source: Chinasoft International

Exhibit 65: Management profiles

Current Position	Name	Major Experience	Education Background
Chairman	Mr. Chen Yuhong 陳宇紅	Different management roles (Deputy general manager, Vice president, Senior president, President) in software information industry since 1999.	Doctor degree of optics from Beijing Institute of Technology
Senior Vice President	Mr.Tang Zhenming 唐振明	Responsible for the group's training department and was employed by the Beijing Institute of Technology Industrial company as deputy general manager before joining the firm	Doctor degree of motor electronic control from Beijing Institute of Technology
Senior Vice President	Mr. Simon Zhang 張崇濱	Chief human resource officer in the firm. Worked for Chongqing Three Gorges Linear corporation and Phoenix Medical Equipment company previously	Bachelor degree of economics from Northwest University
COO	Mr. Simon Chung 鍾鎮銘	Over 20 years of experience in IT professional service covering lots of industries. Now a COO and CEO in ITO business of Japan	Bachelor degree in computing mathematics from the University of Wollongong
Controller	Ms. Leong Leung Chai 梁良齊	Financial Controller of the company. Ms. Leong joined Chinasoft in 2005. She has several years of experience in auditing firms	Bachelor degree in accountancy

Source: Chinasoft International

Corporate governance

Board structure

Number of Independent Directors (ID)	3
Percentage of IDs in the board	37.5%
ID participation/attendance at board meetings	47%
ID participation in audit/remuneration committees	92%
ID terms (years of service, re-election/replacement procedures)	3 years

Sources: Company; BNP Paribas

Additional comment: Currently, there are three independent directors, who all have a finance background. One independent director started their tenure in 2016, to replace the previous independent director whose tenure had ended. Notably, we believe the ID participation rate is lower than average.

Audit practises

Auditor	Deloitte
Length of service	More than nine years
Reporting incidents	N/A
Fee track record	RMB5.6m for 2014
Policy on change of Audit firm	N/A

Sources: Company; BNP Paribas

Additional comment: Deloitte has provided auditing services for Chinasoft since it listed on the main board of HKSE and has not reported any incident since then. We see the stable auditor as a good sign of Chinasoft's corporate governance.

Compensation and remuneration

Directors' remuneration vs. earnings/ROE/share performance	RMB8.4m in 2016 (2.1% of 2016 earnings)
Changes/stability in senior management	Stable
Incidents of termination of senior management	N/A
Track record on Insider sales	N/A

Sources: Company; BNP Paribas

Additional comment: We believe Chinasoft directors and management are experienced and stable, without a big reshuffle in past years; thus, we see little risk of major changes in management team.

Shareholders' rights

Communication - shareholder participation in AGMs/EGMs	N/A
Related party transactions	N/A
Voting issues - policies, incidents of rejected proposals	None

Sources: Company; BNP Paribas

Financial statements

Chinasoft International

Profit and Loss (RMB m) Year Ending Dec	2015A	2016A	2017E	2018E	2019E
Revenue	5,129	6,783	9,021	10,929	13,084
Cost of goods sold	(3,555)	(4,711)	(6,281)	(7,595)	(9,092)
Gross profit	**1,574**	**2,072**	**2,740**	**3,333**	**3,992**
Other operating income	0	0	0	0	0
Operating costs	(1,001)	(1,371)	(1,914)	(2,290)	(2,685)
Operating EBITDA	**573**	**701**	**826**	**1,044**	**1,307**
Depreciation	(51)	(56)	(65)	(75)	(80)
Goodwill amortisation	0	0	0	0	0
Operating EBIT	**522**	**645**	**761**	**969**	**1,227**
Net financing costs	(93)	(96)	(100)	(100)	(100)
Associates	2	17	(16)	0	0
Recurring non operating income	(10)	(25)	(36)	(20)	(20)
Non recurring items	0	0	0	0	0
Profit before tax	**420**	**525**	**625**	**849**	**1,107**
Tax	(87)	(115)	(63)	(102)	(133)
Profit after tax	**333**	**410**	**562**	**747**	**974**
Minority interests	(53)	32	5	0	0
Preferred dividends	0	0	0	0	0
Other items	0	0	0	0	0
Reported net profit	**280**	**442**	**567**	**747**	**974**
Non recurring items & goodwill (net)	**0**	**0**	**0**	**0**	**0**
Recurring net profit	**280**	**442**	**567**	**747**	**974**
Per share (RMB)					
Recurring EPS *	0.14	0.20	0.24	0.31	0.41
Reported EPS	0.14	0.20	0.24	0.31	0.41
DPS	0	0.01	0.01	0.02	0.02
Diluted shares (used to calculate per share data)	1,993	2,173	2,402	2,402	2,402
Growth					
Revenue (%)	15.8	32.3	33.0	21.1	19.7
Operating EBITDA (%)	24.3	22.4	17.8	26.3	25.2
Operating EBIT (%)	30.4	23.5	18.0	27.2	26.6
Recurring EPS (%)	31.1	44.7	16.0	31.7	30.4
Reported EPS (%)	31.1	44.7	16.0	31.7	30.4
Operating performance					
Gross margin inc depreciation (%)	29.7	29.7	29.7	29.8	29.9
Operating EBITDA margin (%)	11.2	10.3	9.2	9.5	10.0
Operating EBIT margin (%)	10.2	9.5	8.4	8.9	9.4
Net margin (%)	5.5	6.5	6.3	6.8	7.4
Effective tax rate (%)	0.2	0.2	0.1	0.1	0.1
Dividend payout on recurring profit (%)	0.0	6.5	5.8	5.8	5.8
Interest cover (x)	5.5	6.5	7.3	9.5	12.1
Inventory days	3.2	2.0	1.6	1.8	1.9
Debtor days	203.9	177.8	162.9	159.3	151.0
Creditor days	107.9	94.1	78.0	70.1	70.4
Operating ROIC (%)	23.2	23.9	21.8	22.5	25.4
ROIC (%)	13.9	14.9	14.6	16.4	19.1
ROE (%)	9.8	11.8	12.5	14.5	16.3
ROA (%)	7.3	7.4	8.9	10.3	11.5

*Pre exceptional pre-goodwill and fully diluted

Revenue By Division (RMB m)	2015A	2016A	2017E	2018E	2019E
Technical & Professional service Group	3,781	5,482	7,280	8,652	10,073
Internet IT service Group	1,348	1,301	1,741	2,277	3,011

Sources: Chinasoft International; BNP Paribas estimates

Financial statements

Chinasoft International

Cash Flow (RMB m) Year Ending Dec	2015A	2016A	2017E	2018E	2019E
Recurring net profit	280	442	567	747	974
Depreciation	51	56	65	75	80
Associates & minorities	0	0	0	0	0
Other non-cash items	176	86	0	0	0
Change in working capital	(247)	(292)	(900)	(373)	(341)
Cash flow from operations	**260**	**292**	**(268)**	**449**	**713**
Capex - maintenance	0	0	0	0	0
Capex - new investment	(272)	(304)	(270)	(250)	(230)
Net acquisitions & disposals	2	32	0	0	0
Other investments (net)	(55)	22	0	0	0
Cash flow from Investing	**(326)**	**(251)**	**(270)**	**(250)**	**(230)**
Dividends paid	0	0	(29)	(33)	(43)
Equity finance	285	202	0	0	0
Debt finance	0	459	0	0	0
Other financing cash flows	232	(675)	0	0	0
Cash flow from Financing	**518**	**(14)**	**(29)**	**(33)**	**(43)**
Non recurring cash flows	-	-	-	-	-
Other adjustments	3	6	0	0	0
Net other adjustments	**3**	**6**	**0**	**0**	**0**
Movement in cash	**454**	**33**	**(567)**	**166**	**440**
Per share (RMB)					
Free cash flow to firm (FCFF)	26.30	136.93	(438.08)	299.02	582.87
Free cash flow to equity (FCFE)	169.11	(169.03)	(538.08)	199.02	482.87
FCFF per share	0.01	0.06	(0.18)	0.12	0.24
FCFE per share	0.08	(0.08)	(0.22)	0.08	0.20
Recurring cash flow per share	0.25	0.27	0.26	0.34	0.44

Balance Sheet (RMB m) Year Ending Dec	2015A	2016A	2017E	2018E	2019E
Tangible fixed assets (gross)	538	820	1,025	1,200	1,350
Less: Accumulated depreciation	0	0	0	0	0
Tangible fixed assets (Net)	**538**	**820**	**1,025**	**1,200**	**1,350**
Intangible fixed assets (Net)	**1,279**	**1,240**	**1,240**	**1,240**	**1,240**
Long-term financial assets	49	62	62	62	62
Invest. in associates & subsidiaries	79	104	104	104	104
Cash & equivalents	1,266	1,299	732	898	1,338
A/C receivable	3,004	3,606	4,449	5,090	5,735
Inventories	30	21	35	42	50
Other current assets	46	2	2	2	2
Current assets	**4,346**	**4,927**	**5,217**	**6,032**	**7,125**
Other assets	58	76	76	76	76
Total assets	**6,348**	**7,229**	**7,724**	**8,714**	**9,957**
Common equity	3,247	4,264	4,803	5,516	6,447
Minorities etc	239	68	68	68	68
Total Shareholders' equity	**3,486**	**4,333**	**4,871**	**5,585**	**6,515**
Long term debt	263	439	439	439	439
Other long-term liabilities	60	19	19	19	19
Long-term liabilities	**323**	**458**	**458**	**458**	**458**
A/C payable	1,065	1,365	1,321	1,597	1,910
Short term debt	1,387	922	922	922	922
Other current liabilities	87	152	152	152	152
Current liabilities	**2,539**	**2,439**	**2,395**	**2,671**	**2,984**
Total liabilities	**6,348**	**7,229**	**7,724**	**8,714**	**9,957**
Net working capital	1,928	2,112	3,012	3,385	3,726
Invested capital	3,930	4,414	5,519	6,067	6,558

* includes convertibles and preferred stock which is being treated as debt

Per share (RMB)	2015A	2016A	2017E	2018E	2019E
Book value per share	1.63	1.96	2.00	2.30	2.68
Tangible book value per share	0.99	1.39	1.48	1.78	2.17
Financial strength					
Net debt/Equity (%)	11.0	1.4	12.9	8.3	0.4
Net debt/total assets (%)	6.1	0.9	8.1	5.3	0.2
Current ratio (x)	1.7	2.0	2.2	2.3	2.4
CF interest cover (x)	5.8	2.4	n/a	5.5	8.1

Valuation	2015A	2016A	2017E	2018E	2019E
Recurring P/E (x) *	31.2	21.6	18.6	14.1	10.8
Recurring P/E @ target price (x) *	38.4	26.5	22.8	17.3	13.3
Reported P/E (x)	31.2	21.6	18.6	14.1	10.8
Dividend yield (%)	0.0	0.3	0.3	0.4	0.5
P/CF (x)	17.2	16.3	16.7	12.8	10.0
P/FCF (x)	51.7	n/a	n/a	53.0	21.8
Price/book (x)	2.7	2.2	2.2	1.9	1.6
Price/tangible book (x)	4.4	3.2	3.0	2.5	2.0
EV/EBITDA (x) **	16.4	13.8	13.6	10.6	8.1
EV/EBITDA @ target price (x) **	19.9	16.9	16.5	12.9	10.0
EV/invested capital (x)	2.4	2.2	2.0	1.8	1.6

* Pre exceptional & pre-goodwill and fully diluted ** EBITDA includes associate income and recurring non operating income

Sources: Chinasoft International; BNP Paribas estimates

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Company	Ticker	Price	Rating	Valuation & Risks
Chinasoft International	354 HK	HKD 5.45	Buy	Downside risks to our P/E-based TP: 1) ASP erosion from increased competition, 2) uncertainty about the overseas business, 3) a softer China IT services market, and 4) unfavourable currency trend. Upside risk: 1) better China IT service market, 2) Overseas IT service opportunity, 3) supportive policy release from China gov., and 4) favourable currency trend.

Sources: Factset; BNP Paribas

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