

23 January 2019

Software & Internet | IT Services

Chinasoft International (354 HK)

Buy (Maintained)

New Businesses Face Challenges; Keep BUY

Target Price (Return) HKD6.65 (+85%)
 Price: HKD3.59
 Market Cap: USD11,41m
 Avg Daily Turnover (HKD/USD) 61m/8m

- **Keep BUY with a new HKD6.65 TP from HKD7.77, 85% upside.** We cut Chinasoft International's FY18F-19F earnings 7% and 15% to reflect our concerns over the growth its new businesses, especially the *JointForce* platform. On the bright side, we are seeing revenue from its largest customer – Huawei – accelerating, which should help guarantee solid growth in FY19.
- **New businesses face challenges.** One of the revenue streams for *JointForce* is software parks – this one is paid for by the Government. With the public sector budget tightening for lower value-add IT projects, we see Chinasoft possibly falling short of its original revenue target for this stream. We also see slower ramp-up of Huawei's cloud offerings – a reason for Chinasoft's cloud revenue falling a bit short of its prior target.
- **Revenue from Huawei to re-accelerate in FY19.** Huawei is expected to grow its revenue 20% in 2019. We are also seeing the firm increasing its spending on research & development in areas such as 5G. Consequently, we expect revenue contributions from Huawei to Chinasoft resuming at higher growth levels in FY19 – ie above 10% – when compared to single-digit growth in FY18.
- **Forecast changes.** We lower the company's revenue forecasts, mainly on new businesses – especially *JointForce*. Also, as we expect lower-margin businesses to resume at faster growth levels – ie revenue from Huawei – we cut our margins forecasts. As a result, we slash Chinasoft's FY18F-19F earnings 7% and 15%.
- **Our new TP is based on the same FY19F P/E of 16x,** but we use less diluted EPS – this is because one of its convertible bonds is now below water. Downside risks include a high concentration of large customers, weaker demand due to a weak economy, and potential labour cost increases.

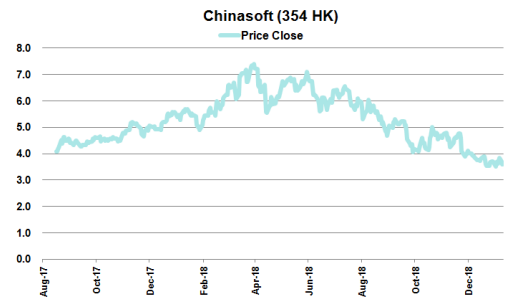
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Share Performance (%)

	YTD	1m	3m	6m	12m
Absolute	(7.7)	(7.0)	(22.0)	(42.1)	(36.2)
Relative	(12.2)	(11.9)	(25.2)	(37.8)	(19.5)
52-wk Price low/high (HKD)	3.45 – 7.70				



Source: Bloomberg

Forecasts and Valuation	Dec-16	Dec-17	Dec-18F	Dec-19F	Dec-20F
Total turnover (CNYm)	6,783	9,244	10,606	12,251	14,237
Net profit (CNYm)	3,085	3,462	3,078	3,208	3,303
Net profit growth (%)	57.9	27.9	25.0	16.4	22.0
Recurring EPS (CNY)	0.20	0.3	0.29	0.3	0.31
Recurring P/E (x)	14.5	9.8	10.1	9.8	9.5
P/B (x)	1.5	1.4	1.2	1.1	0.9
Dividend Yield (%)	0	0	0	0	0
EV/EBITDA (x)	6.4	7.0	5.7	5.1	4.3
ROAE (%)	10.9	11.9	12.8	13.2	14.1
Net debt to equity (%)	1.4	Net Cash	1.1	Net Cash	Net Cash

Source: Company data, RHB

Figure 1: Forecast changes

(CNY '000)	FY18F			FY19F		
	Original	New	Change	Original	New	Change
Internet IT services business	1,595,561	1,466,753	(8.1%)	1,846,065	1,548,891	(16.1%)
Technical professional services busi	9,681,854	9,139,608	(5.6%)	11,627,907	10,702,481	(8.0%)
Total revenue	11,277,416	10,606,361	(6.0%)	13,473,972	12,251,372	(9.1%)
Cost of sales and services	(7,858,103)	(7,390,512)	(6.0%)	(9,365,758)	(8,576,573)	(8.4%)
Gross profit	3,419,312	3,215,849	(6.0%)	4,108,214	3,674,799	(10.5%)
<i>Gross profit margin</i>	30.3%	30.3%		30.5%	30.0%	
Selling & Marketing expenses	(448,841)	(422,133)	(6.0%)	(525,485)	(504,757)	(3.9%)
G&A expenses	(1,277,731)	(1,201,701)	(6.0%)	(1,525,254)	(1,359,902)	(10.8%)
R&D expenses	(690,178)	(649,109)	(6.0%)	(824,607)	(747,334)	(9.4%)
Other income / (expenses)	(68,095)	(69,437)	2.0%	(80,476)	(81,698)	1.5%
Operating profit	934,467	873,469	(6.5%)	1,152,393	981,108	(14.9%)
<i>Operating profit margin</i>	8.3%	8.2%		8.6%	8.0%	
Interest income	6,360	6,751	6.2%	5,973	6,810	14.0%
Interest expense	(115,256)	(115,256)	-	(115,755)	(105,756)	(8.6%)
Share of profits of associates	29,645	29,645	-	42,985	42,985	-
Profit / Loss before income tax e	855,215	794,608	(7.1%)	1,085,595	925,146	(14.8%)
Income tax benefit / (expense)	(94,074)	(87,407)	(7.1%)	(119,415)	(101,766)	(14.8%)
Non-controlling interests	250	250	-	360	360	-
Net profit - Reported	760,891	706,951	(7.1%)	965,820	823,020	(14.8%)
<i>NPM</i>	6.7%	6.7%		7.2%	6.7%	
Net profit - Recurring	760,891	706,951	(7.1%)	965,820	823,020	(14.8%)
<i>NPM - adjusted</i>	6.7%	6.7%		7.2%	6.7%	

Source: Company data, RHB

Figure 2: Chinasoft's annual P&L

FYE Dec 31								
CNY '000	FY13	FY14	FY15	FY16	FY17	FY18F	FY19F	FY20F
Internet IT services	n.a	1,191,372	1,348,419	1,301,446	1,385,036	1,466,753	1,548,891	1,768,834
<i>Growth%</i>	<i>n.a</i>	<i>n.a</i>	<i>0</i>	<i>(3.5%)</i>	<i>6.4%</i>	<i>5.9%</i>	<i>5.6%</i>	<i>14.2%</i>
Technical professional services	n.a	3,237,830	3,780,692	5,481,921	7,858,648	9,139,608	10,702,481	12,468,390
<i>Growth%</i>	<i>n.a</i>	<i>n.a</i>	<i>16.8%</i>	<i>45.0%</i>	<i>43.4%</i>	<i>16.3%</i>	<i>17.1%</i>	<i>16.5%</i>
Total Revenue	3,205,985	4,429,202	5,129,111	6,783,367	9,243,684	10,606,361	12,251,372	14,237,224
<i>Growth%</i>	<i>15.8%</i>	<i>38.2%</i>	<i>15.8%</i>	<i>32.3%</i>	<i>36.3%</i>	<i>14.7%</i>	<i>15.5%</i>	<i>16.2%</i>
Cost of sales and services	(2,200,799)	(3,080,046)	(3,605,903)	(4,767,529)	(6,493,218)	(7,390,512)	(8,576,573)	(9,980,294)
Gross profit	1,005,186	1,349,156	1,523,208	2,015,838	2,750,466	3,215,849	3,674,799	4,256,930
<i>Margin%</i>	<i>31.4%</i>	<i>30.5%</i>	<i>29.7%</i>	<i>29.7%</i>	<i>29.8%</i>	<i>30.3%</i>	<i>30.0%</i>	<i>29.9%</i>
Selling and distribution costs	(175,369)	(219,789)	(178,581)	(219,022)	(369,729)	(422,133)	(504,757)	(587,997)
Administrative expenses	(512,223)	(664,752)	(627,264)	(806,614)	(1,086,325)	(1,201,701)	(1,359,902)	(1,566,095)
Research and development expenses	(52,156)	(64,161)	(195,318)	(345,269)	(567,313)	(649,109)	(747,334)	(854,233)
Allowance for doubtful debts	(24,613)	(27,103)	(62,055)	(17,958)	(25,862)	(31,819)	(36,754)	(42,712)
Amortisation of intangible assets	(49,803)	(80,676)	(91,961)	(88,012)	(81,742)	(88,025)	(91,325)	(94,625)
Impairment loss - goodwill	0	0	0	0	0	0	0	0
Other income, gains and losses	59,878	83,909	41,943	37,127	94,764	50,407	46,380	47,205
Operating profit	250,900	376,584	409,972	576,090	714,259	873,469	981,108	1,158,473
<i>Margin%</i>	<i>7.8%</i>	<i>8.5%</i>	<i>8.0%</i>	<i>8.5%</i>	<i>7.7%</i>	<i>8.2%</i>	<i>8.0%</i>	<i>8.1%</i>
Interest income	1,958	2,847	4,316	4,781	5,727	6,751	6,810	3,629
Interest expenses	(47,296)	(84,385)	(92,509)	(95,735)	(102,915)	(115,256)	(105,756)	(95,856)
Share of results of associates	(1,138)	1,429	1,907	17,492	19,763	29,645	42,985	62,328
Others gains / (loss)	494	764	96,308	21,959	(4,065)	0	0	0
Profit before taxation	204,918	297,239	419,994	524,587	632,769	794,608	925,146	1,128,574
<i>Margin%</i>	<i>6.4%</i>	<i>6.7%</i>	<i>8.2%</i>	<i>7.7%</i>	<i>6.8%</i>	<i>7.5%</i>	<i>7.6%</i>	<i>7.9%</i>
Income tax expense	(4,890)	(42,183)	(87,010)	(114,754)	(71,462)	(87,407)	(101,766)	(124,143)
<i>Effective tax rate%</i>	<i>2.4%</i>	<i>14.2%</i>	<i>20.7%</i>	<i>21.9%</i>	<i>11.3%</i>	<i>11.0%</i>	<i>11.0%</i>	<i>11.0%</i>
Profit for the year	200,028	255,056	332,984	409,833	561,307	707,201	823,380	1,004,431
<i>Growth%</i>	<i>33.2%</i>	<i>27.5%</i>	<i>30.6%</i>	<i>23.1%</i>	<i>37.0%</i>	<i>26.0%</i>	<i>16.4%</i>	<i>22.0%</i>
Non-controlling interests	51,727	55,018	52,928	(32,248)	(4,260)	250	360	370
Reported net profit	148,301	200,038	280,056	442,081	565,567	706,951	823,020	1,004,061
<i>Growth%</i>	<i>11.3%</i>	<i>34.9%</i>	<i>40.0%</i>	<i>57.9%</i>	<i>27.9%</i>	<i>25.0%</i>	<i>16.4%</i>	<i>22.0%</i>
<i>Margin%</i>	<i>4.6%</i>	<i>4.5%</i>	<i>5.5%</i>	<i>6.5%</i>	<i>6.1%</i>	<i>6.7%</i>	<i>6.7%</i>	<i>7.1%</i>

Source: RHB

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