

22 August 2018

Technology | Software & Services

Kingsoft

Buy (Maintained)

Undervalued, Though Online Game Headwinds Persist

Overall, we think many negatives have been priced in, so we maintain **BUY** with lower TP of HKD27.25 from HKD32.50, for 92% upside. 2Q18 results were largely in line with its previously issued profit alert, or slightly better on a non-operating item (profit from associate). Still, going forward, we see headwinds for the online game sector, with user time switching to survival games and short videos, as well as the overhang of regulatory uncertainties. We slash FY18F-19F earnings mainly on JX III Mobile game launch delay, as well as higher opex percentage. On the bright side, WPS growth was strong, driven by membership fees. We expect the WPS spin-off and JX III launch in FY19 to be stock catalysts over the following 12 months.

Online game headwinds. The online game sector in general has seen some headwinds in terms of revenue, as user time has switched to short videos and survival games (the two major survival games in the market cannot be monetised, pending regulatory approval). This is reflected in Kingsoft's decision to postpone the launch of JX Mobile III to FY19 (previously Oct 2018), with better timing more likely to generate a more successful launch.

Strong WPS business. The current revenue percentage from the personal edition has now increased to 60% of Kingsoft's total office software business (WPS) revenue, with the fastest-growing membership fee. We consider this positive, as membership fees are more recurring and sustainable than advertising revenue. As such, we raise our revenue forecast for WPS.

Mixed cloud business outlook. Kingsoft managed to grow its cloud business by 54% YoY in 2Q18, though the absolute loss amount has increased as a result of intensified price war in the space. We have a mixed view on its cloud business – on one hand, we acknowledge its strength in game and video cloud, but on the other, we are concerned about price war and competition from large players.

Financial outlook. We cut our FY18F-19F earnings by 73% and 32%, mainly on the delay of the JX Mobile III launch as well as higher opex. We expect 3Q18 to be under the same pressure as 2Q18. 4Q18 may see some recovery on revenue growth and margins, following its JX Mobile II game launch as well as the launch of the expansion pack for its JX III PC game.

Maintain BUY, reducing TP to HKD27.75. Our SOP-derived TP implies 53x and 21x FY18F-19F P/Es. Downside risks include a more-severe-than-expected cloud price war and delay in game launches.

Target Price:	HKD27.75
Price:	HKD14.40
Market Cap:	USD2,527m
Bloomberg Ticker:	3888 HK

Share Data

Avg Daily Turnover (HKD/USD)	234m/29.9m
52-wk Price low/high (HKD)	13.1 - 29.6
Free Float (%)	55
Shares outstanding (m)	1,299
Estimated Return	92%

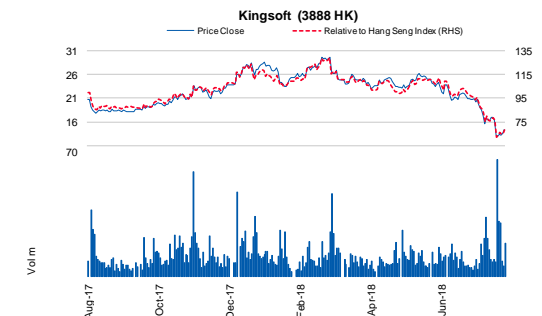
Shareholders (%)

Management	27.1
Tencent	8.2

Share Performance (%)

	YTD	1m	3m	6m	12m
Absolute	(44.5)	(30.9)	(38.2)	(44.7)	(29.1)
Relative	(37.2)	(29.2)	(27.0)	(33.0)	(31.3)

Source: Bloomberg



Source: Bloomberg

Forecasts and Valuations	Dec-16	Dec-17	Dec-18F	Dec-19F	Dec-20F
Total turnover (CNYm)	3,834	5,181	5,756	8,530	11,465
Reported net profit (CNYm)	(271)	978	391	1,364	2,112
Recurring net profit (CNYm)	954	1,213	596	1,544	2,292
Recurring net profit growth (%)	73.4	27.2	(50.9)	159.2	48.4
Recurring EPS (CNY)	0.74	0.91	0.44	1.13	1.68
DPS (CNY)	0.09	0.09	0.09	0.09	0.09
Recurring P/E (x)	17.0	13.8	28.9	11.1	7.5
P/B (x)	2.06	1.42	1.40	1.27	1.11
P/CF (x)	17.5	9.7	12.7	9.6	5.7
Dividend Yield (%)	0.7	0.7	0.7	0.7	0.7
EV/EBITDA (x)	6.33	2.09	6.44	1.92	1.19
Return on average equity (%)	(3.4)	9.8	3.2	10.6	14.5
Net debt to equity	net cash	net cash	net cash	net cash	net cash
Our vs consensus EPS (adjusted)					

Source: Company data, RHB

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Financial Exhibits

Financial model updated on : 2018-08-22.

Asia
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Buy

Valuation basis

We use SOP to value Kingsoft as its business is quite diverse and includes online games, software and Internet, and cloud services, which fits different valuation methodologies.

Key drivers

- Mobile game launch;
- Continued solid growth from PC Game JX Online;
- Monetisation on WPS mobile version;
- Cheetah improving user engagement through content products;
- Cloud business further expanding reach to other large clients and sector verticals.

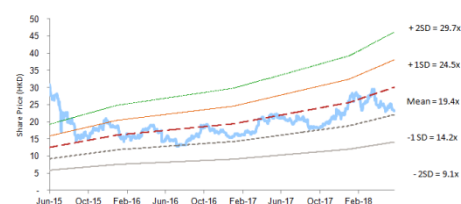
Key risks

- Potential failure of its new mobile games;
- Price wars for cloud services;
- Adverse impact on advertising revenue from a weak economy.

Company Profile

Kingsoft is a well-established online PC games and software developer and operator. The company's major game, JX Online III, is an extension of its well-known JX series, while its antivirus and internet security software are popular among government entities, corporations and individuals in China. Leveraging on its popular security software, Kingsoft has now expanded into mobile applications, which are highly ranked on both Apple's (APPL US, NR) and Google's (GOOG US, NR) app stores. The company also plans to build itself into a leading cloud service provider in China.

Kingsoft's past 3-year forward P/E band



Source: Bloomberg, RHB

Financial summary	Dec-16	Dec-17	Dec-18F	Dec-19F	Dec-20F
Recurring EPS (CNY)	0.74	0.91	0.44	1.13	1.68
EPS (CNY)	(0.21)	0.74	0.29	1.00	1.55
DPS (CNY)	0.09	0.09	0.09	0.09	0.09
BVPS (CNY)	6.1	8.8	9.0	9.9	11.4
Weighted avg adjusted shares (m)	1,288	1,328	1,367	1,367	1,367

Valuation metrics	Dec-16	Dec-17	Dec-18F	Dec-19F	Dec-20F
Recurring P/E (x)	17.0	13.8	28.9	11.1	7.5
P/E (x)	na	17.1	44.0	12.6	8.2
P/B (x)	2.06	1.42	1.40	1.27	1.11
FCF Yield (%)	2.2	5.4	4.3	5.0	10.4
Dividend Yield (%)	0.7	0.7	0.7	0.7	0.7
EV/EBITDA (x)	6.33	2.09	6.44	1.92	1.19
EV/EBIT (x)	9.4	3.5	24.1	2.6	1.5

Income statement (CNYm)	Dec-16	Dec-17	Dec-18F	Dec-19F	Dec-20F
Total turnover	3,834	5,181	5,756	8,530	11,465
Gross profit	2,541	3,012	2,886	4,765	6,498
EBITDA	1,376	1,382	549	1,999	3,078
Depreciation and amortisation	(451)	(568)	(403)	(501)	(648)
Operating profit	925	814	147	1,498	2,430
Net interest	51	83	(39)	(77)	(20)
Income from associates & JVs	95	172	253	309	323
Exceptional income - net	(1,152)	(156)	0	0	0
Pre-tax profit	(82)	912	362	1,730	2,733
Taxation	(177)	(134)	(217)	(346)	(547)
Minority interests	(12)	199	247	(20)	(75)
Recurring net profit	954	1,213	596	1,544	2,292

Cash flow (CNYm)	Dec-16	Dec-17	Dec-18F	Dec-19F	Dec-20F
Change in working capital	(302)	243	649	(447)	(357)
Cash flow from operations	928	1,723	1,358	1,785	3,024
Capex	(578)	(821)	(626)	(917)	(1,231)
Cash flow from investing activities	(963)	364	(617)	(914)	(1,229)
Dividends paid	(116)	(120)	(125)	(125)	(125)
Cash flow from financing activities	1,244	(3,480)	(1,089)	(480)	(744)
Cash at beginning of period	8,783	9,993	8,599	8,252	8,642
Net change in cash	1,210	(1,394)	(348)	391	1,051
Ending balance cash	9,993	8,599	8,252	8,642	9,693

Balance sheet (CNYm)	Dec-16	Dec-17	Dec-18F	Dec-19F	Dec-20F
Total cash and equivalents	10,198	8,687	8,252	8,642	9,693
Tangible fixed assets	1,366	1,619	1,842	2,257	2,840
Intangible assets	1,250	66	57	55	52
Total investments	1,694	5,388	5,388	5,388	5,388
Total other assets	163	144	293	380	483
Total assets	17,579	17,762	17,708	19,535	22,188
Short-term debt	380	374	374	374	374
Total long-term debt	438	288	288	288	288
Other liabilities	20	0	0	0	0
Total liabilities	7,577	5,209	4,943	5,531	6,197
Shareholders' equity	7,887	12,089	12,300	13,539	15,526
Minority interests	2,115	464	464	464	464
Total equity	10,002	12,553	12,765	14,004	15,991
Net debt	(6,152)	(7,037)	(6,602)	(6,992)	(8,043)
Total liabilities & equity	17,579	17,762	17,708	19,535	22,188

Key metrics	Dec-16	Dec-17	Dec-18F	Dec-19F	Dec-20F
Revenue growth (%)	88.6	35.2	11.1	48.2	34.4
Recurrent EPS growth (%)	72.0	23.3	(52.3)	159.2	48.4
Gross margin (%)	66.3	58.1	50.1	55.9	56.7
Operating EBITDA margin (%)	35.9	26.7	9.5	23.4	26.8
Net profit margin (%)	(7.1)	18.9	6.8	16.0	18.4
Dividend payout ratio (%)	(42.7)	12.3	32.0	9.2	5.9
Capex/sales (%)	15.1	15.8	10.9	10.7	10.7
Interest cover (x)	8.64	7.24	0.42	3.53	5.69

Source: Company data, RHB

Figure 1: Quarterly results

FYE Dec 31 (CNYm)	4Q16	1Q17	2Q17	3Q17	4Q17	1Q18	2Q18	2Q18	
	Actual	Actual	Actual	Actual	Actual	Actual	Actual	QoQ	YoY
Online games	820.1	817.2	805.0	746.7	751.4	632.4	581.9	-8.0%	-27.7%
Cloud	255.3	268.4	304.0	358.1	401.9	418.9	468.7	11.9%	54.2%
Office softwear & others	217.6	127.8	175.4	198.3	227.2	212.4	295.2	39.0%	68.3%
Total revenue	1,292.9	1,213.4	1,284.4	1,303.0	1,380.5	1,263.7	1,345.8	6.5%	4.8%
YoY	-27.3%	82.1%	71.0%	16.0%	6.8%	4.2%	4.8%		
Cost of revenue	(427.3)	(509.4)	(488.9)	(558.7)	(611.8)	(648.1)	(674.5)	4.1%	38.0%
Gross profit	865.6	703.9	795.5	744.3	768.7	615.6	671.3	9.0%	-15.6%
YoY	-36.3%	48.2%	59.6%	6.0%	-11.2%	-12.5%	-15.6%		
Gross profit margin	66.9%	58.0%	61.9%	57.1%	55.7%	48.7%	49.9%		
R&D costs	(310.1)	(321.4)	(368.3)	(355.0)	(401.3)	(380.3)	(430.6)	13.2%	16.9%
Selling expenses	(106.3)	(81.2)	(135.3)	(154.1)	(174.4)	(126.6)	(157.8)	24.6%	16.6%
Admin expenses	(50.1)	(56.1)	(58.6)	(63.0)	(79.1)	(82.9)	(105.9)	27.7%	80.5%
Other op costs	(8.1)	(2.1)	(4.3)	(2.9)	(0.3)	(0.6)	(1.2)		
SBC	(6.6)	(48.7)	(61.1)	(74.3)	(51.1)	(58.1)	(51.8)		
Other income	22.4	70.8	92.8	55.5	75.0	58.9	89.4		
Operating profit	406.8	265.2	260.8	150.4	137.5	26.0	13.3	-48.7%	-94.9%
YoY	61.8%	141.1%	102.2%	-46.2%	-66.2%	-90.2%	-94.9%		
Operating margin	31.5%	21.9%	20.3%	11.5%	10.0%	2.1%	1.0%		
Net finance income	12.0	15.1	23.0	23.8	20.7	14.2	(4.5)		
JV & associates	44.5	36.4	29.6	7.7	98.4	37.1	81.3		
Gain on disposal&others	(140.5)	(92.3)	(42.3)	5.0	(26.9)	19.2	(73.6)		
PBT	322.8	224.5	271.0	186.9	229.7	96.5	16.4	-83.0%	-93.9%
Tax	(59.6)	(46.1)	(48.2)	(45.0)	5.5	(43.1)	(57.0)		
Effective tax rate (%)	18.5%	20.5%	17.8%	24.1%	-2.4%	44.7%	346.9%		
Profit from continuing operations	263.2	178.4	222.8	141.9	-	-	-		
Profit from a discontinued operation	69.9	101.9	61.8	130.3	-	-	-		
Gain on deemed disposal of a subsidi	-	-	-	-	2,224.3	-	-		
MI	71.8	41.8	34.6	33.7	(15.4)	(65.0)	(141.5)		
Net profit - reported	261.3	238.5	250.0	238.5	2,474.9	118.4	100.9	-14.7%	-59.6%
YoY	131.0%	78.2%	-131.0%	68.3%	847.0%	-50.4%	-59.6%		
NPM - reported	20.2%	19.7%	19.5%	18.3%	179.3%	9.4%	7.5%		
Net Profit - non-GAAP	371.4	325.5	320.7	238.7	328.6	157.3	226.4	44.0%	-29.4%
YoY	56.9%	173.7%	92.7%	-19.8%	-11.5%	-51.7%	-29.4%		
NPM - non-GAAP	28.7%	26.8%	25.0%	18.3%	23.8%	12.4%	16.8%		

Source: RHB, Company data, Bloomberg

Figure 2: Earnings changes

FYE Dec 31 (CNYm)	FY18F			FY19F			FY20F		
	Original	New	Change	Original	New	Change	Original	New	Change
Online games	3,588.7	2,593.8	-27.7%	4,877.6	4,001.0	-18.0%	5,765.2	5,154.6	-10.6%
Cloud	2,190.9	2,048.1	-6.5%	3,308.3	2,985.3	-9.8%	4,642.6	4,187.2	-9.8%
Office software and others	1,092.8	1,114.6	2.0%	1,466.5	1,543.4	5.2%	1,986.0	2,123.4	6.9%
Total revenue	6,872.4	5,756.5	-16.2%	9,652.5	8,529.7	-11.6%	12,393.7	11,465.3	-7.5%
Cost of Revenue	(3,068.2)	(2,870.9)	-6.4%	(4,258.6)	(3,765.0)	-11.6%	(5,369.8)	(4,967.5)	-7.5%
Gross profit	3,804.1	2,885.6	-24.1%	5,393.9	4,764.7	-11.7%	7,023.9	6,497.7	-7.5%
Gross profit margin	55.4%	50.1%		55.9%	55.9%		56.7%	56.7%	
R&D costs	(1,636.1)	(1,739.1)	6.3%	(2,300.8)	(2,161.8)	-6.0%	(2,838.9)	(2,759.7)	-2.8%
Selling expenses	(621.6)	(618.3)	-0.5%	(861.4)	(754.5)	-12.4%	(1,042.2)	(990.7)	-4.9%
Admin expenses	(338.0)	(424.1)	25.5%	(369.5)	(537.5)	45.5%	(434.4)	(632.1)	45.5%
Other expenses	(11.1)	(7.7)	-31.3%	(19.6)	(17.3)	-11.6%	(25.1)	(23.2)	-7.5%
Share-based expenses	(227.2)	(204.6)	-9.9%	(234.4)	(225.8)	-3.7%	(240.0)	(240.0)	0.0%
Other income	271.8	254.7	-6.3%	487.0	430.3	-11.6%	625.2	578.4	-7.5%
Operating profit	1,241.8	146.6	-88.2%	2,095.3	1,498.2	-28.5%	3,068.5	2,430.4	-20.8%
Operating margin	18.1%	2.5%		21.7%	17.6%		24.8%	21.2%	
Fair value gains	-	-	N/A	-	-	N/A	-	-	N/A
Finance income	235.7	311.6	32.2%	225.0	348.1	54.7%	225.0	407.2	81.0%
Finance costs	(247.7)	(350.1)	N/A	(124.8)	(425.0)	N/A	(122.9)	(427.2)	N/A
JC and associate	166.6	253.4	52.1%	317.4	308.9	-2.7%	323.0	323.0	0.0%
Gain on disposal/(Impairment)	19.2	(54.5)	N/A	-	-	N/A	-	-	N/A
PBT	1,415.6	307.1	-78.3%	2,512.8	1,730.1	-31.1%	3,493.6	2,733.4	-21.8%
Tax	(318.3)	(217.1)		(502.6)	(346.0)		(698.7)	(546.7)	
Effective tax rate	22.5%	70.7%		20.0%	20.0%		20.0%	20.0%	
Profit from continuing operations	1,097.4	90.0		2,010.3	1,384.1		2,794.9	2,186.7	
Profit from a discontinued operation	-	-		-	-		-	-	
Minority Interests	(150.2)	(246.7)		20.0	20.0		75.0	75.0	
Net profit - reported	1,247.6	336.7	-73.0%	1,990.3	1,364.1	-31.5%	2,719.9	2,111.7	-22.4%
NPM - reported (%)	18.2%	5.8%		20.6%	16.0%		21.9%	18.4%	
Net profit - non-GAAP	1,501.8	595.7	-60.3%	2,170.3	1,544.1	-28.9%	2,899.9	2,291.7	-21.0%
NPM - non-GAAP (%)	21.9%	10.3%		22.5%	18.1%		23.4%	20.0%	

Source: RHB

Figure 3: Annual P&L

FYE Dec 31 (CNYm)	FY12	FY13	FY14	FY15	FY16	FY17	FY18F	FY19F	FY20F
Online games	851.4	1,095.9	1,252.8	1,368.8	2,545.7	3,120.2	2,593.8	4,001.0	5,154.6
Cloud	-	-	123.6	271.5	737.2	1,332.5	2,048.1	2,985.3	4,187.2
Office software	-	-	299.7	392.4	550.7	728.6	1,114.6	1,543.4	2,123.4
Total revenue	1,411.2	2,173.3	3,350.1	2,032.7	3,833.5	5,181.3	5,756.5	8,529.7	11,465.3
YoY	38.3%	54.0%	54.2%	-39.3%	88.6%	35.2%	11.1%	48.2%	34.4%
Cost of revenue	(186.9)	(297.1)	(589.7)	(512.7)	(1,292.4)	(2,168.9)	(2,870.9)	(3,765.0)	(4,967.5)
Gross profit	1,224.2	1,876.2	2,760.5	1,520.0	2,541.1	3,012.4	2,885.6	4,764.7	6,497.7
YoY	40.3%	53.3%	47.1%	-44.9%	67.2%	18.5%	-4.2%	65.1%	36.4%
Gross profit margin	86.8%	86.3%	82.4%	74.8%	66.3%	58.1%	50.1%	55.9%	56.7%
R&D costs	(385.4)	(596.5)	(956.1)	(771.0)	(1,084.5)	(1,446.0)	(1,739.1)	(2,161.8)	(2,759.7)
Selling expenses	(234.1)	(382.8)	(797.4)	(250.0)	(323.3)	(545.0)	(618.3)	(754.5)	(990.7)
Admin expenses	(148.0)	(192.2)	(297.4)	(150.0)	(196.9)	(256.8)	(424.1)	(537.5)	(632.1)
Other op costs	(23.0)	(7.3)	(29.9)	(31.0)	(7.7)	(9.5)	(7.7)	(17.3)	(23.2)
SBC	(48.5)	(61.4)	(201.9)	(52.0)	(54.9)	(235.2)	(204.6)	(225.8)	(240.0)
Other gains	28.6	45.9	35.8	60.0	51.3	294.0	254.7	430.3	578.4
Operating profit	413.9	681.9	513.6	326.0	925.1	813.9	146.6	1,498.2	2,430.4
YoY	24.9%	64.7%	-24.7%	-36.5%	183.8%	-12.0%	-82.0%	921.6%	62.2%
Operating margin	29.3%	31.4%	15.3%	16.0%	24.1%	15.7%	2.5%	17.6%	21.2%
Net finance income	89.3	105.0	163.0	116.4	50.9	82.6	(38.5)	(76.9)	(20.0)
JV & associates	8.6	1.1	(14.5)	(43.3)	94.6	172.1	253.4	308.9	323.0
Fair value gains	16.0	(10.4)	(6.4)	-	-	-	-	-	-
Gain on disposal and others	-	47.5	306.1	(75.5)	(1,152.2)	(156.5)	(54.5)	-	-
PBT	527.8	825.1	961.8	323.7	(81.6)	912.1	307.1	1,730.1	2,733.4
Tax	(61.4)	(71.2)	(95.2)	(140.0)	(177.2)	(133.8)	(217.1)	(346.0)	(546.7)
Effective tax rate (%)	11.6%	8.6%	9.9%	43.3%	-217.2%	14.7%	70.7%	20.0%	20.0%
Profit from continuing operations	-	-	-	183.7	(258.7)	778.3	90.0	1,384.1	2,186.7
Profit from a discontinued operation	-	-	-	158.1	(33.6)	294.1	-	-	-
Profit from a discontinued operation	-	-	-	-	-	2,224.3	-	-	-
MI	33.8	83.1	97.8	(27.5)	(21.5)	94.8	(246.7)	20.0	75.0
Net profit - reported	432.6	670.7	768.8	369.2	(270.7)	3,201.8	336.7	1,364.1	2,111.7
YoY	33.2%	55.1%	14.6%	-52.0%	-173.3%	-1282.7%	-89.5%	305.1%	54.8%
NPM - reported	30.7%	30.9%	22.9%	18.2%	-7.1%	61.8%	5.8%	16.0%	18.4%
Net Profit - non-GAAP	465.1	742.5	888.6	550.2	954.2	1,213.4	595.7	1,544.1	2,291.7
YoY	36.9%	59.7%	19.7%	-38.1%	73.4%	27.2%	-50.9%	159.2%	48.4%
NPM - non-GAAP	33.0%	34.2%	26.5%	27.1%	24.9%	23.4%	10.3%	18.1%	20.0%

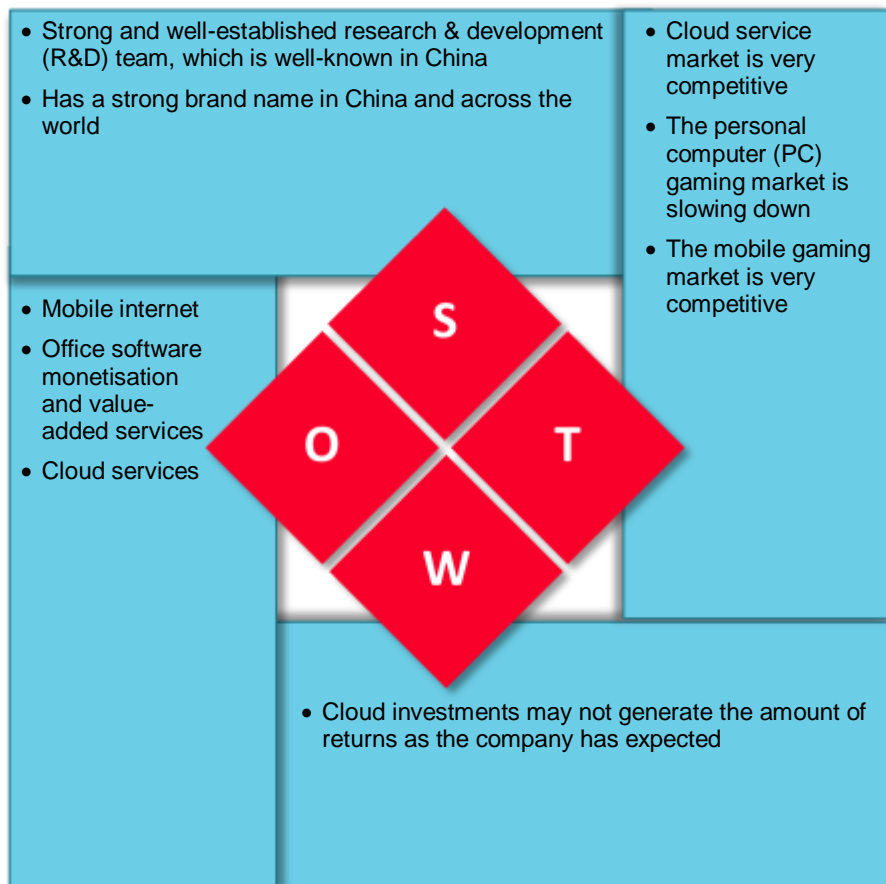
Source: RHB, Company data

Figure 4: SOP valuation table

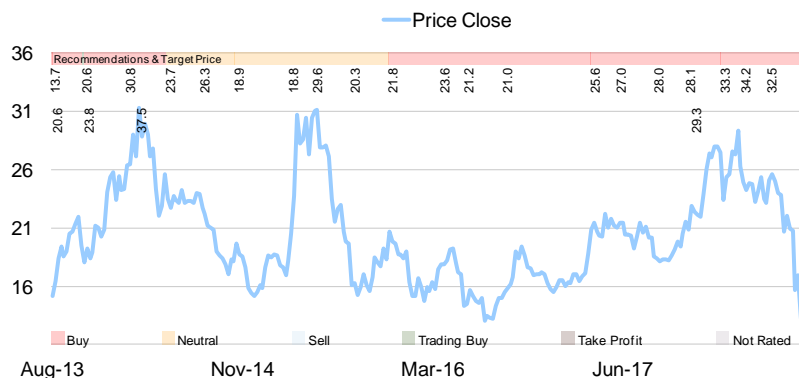
	FY19F EPS (CNY)	FY19F P/E target (x)	KS's Stake	NAV (CNY) /share	NAV (HKD)/share	Holding company discount	TP(HKD)
Games	1.230	9	67.00%	7.42	8.90		8.90
Office Software (Mainly WPS)	0.217	25	67.00%	3.63	4.36		2.62
	Ticker	Market Cap (USDm)		NAV (USD) /share			
CMI	CMCM US	2,580	47%	0.56	4.38	40%	2.63
		Market Cap (USDm)		NAV (USD) /share			
Xunlei	XNET US	600	10%	0.05	0.36	40%	0.22
21Vianet	VNET US	1,160	8%	0.07	0.56	40%	0.33
		Valuation (Series D) (USDm)		NAV (USD) /share			
Cloud		2373	52%	0.95	7.35		7.35
Net cash per share				4.75	5.70		5.70
Total					31.05		27.75

Source: Company data, RHB

SWOT Analysis



Recommendation Chart



Source: RHB, Bloomberg

Date	Recommendation	Target Price	Price
2018-05-24	Buy	32.5	23.8
2018-03-22	Buy	34.2	26.6
2018-01-31	Buy	33.3	26.8
2017-11-22	Buy	29.3	23.7
2017-11-08	Buy	28.1	20.7
2017-08-23	Buy	28.0	20.7
2017-05-24	Buy	27.0	21.6
2017-05-16	Buy	25.6	22.1
2017-03-22	Buy	25.6	20.9
2016-08-22	Buy	21.0	16.0

Source: RHB, Bloomberg

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