

28 March 2019

Software & Internet | IT Services

**Kingsoft (3888 HK)**

**Buy** (Maintained)

**Positive Outlook For All Segments; BUY**

Target Price (Return) HKD24.12 (+22%)  
 Price: HKD19.8  
 Market Cap: USD14,71m  
 Avg Daily Turnover (HKD/USD) 149m/19m

- **Reiterate BUY, new HKD24.12 TP** from HKD21.03, 22% upside with 1% FY19F yield. Kingsoft will launch its mobile game, *JX Mobile III*, in June. We expect this high-quality game to drive FY19-20 earnings significantly. We also like the WPS business for its software as a service (SaaS) model and user-friendly products. FY18 results were better than expected, and management's outlook for FY19 is also encouraging. Kingsoft remains our Top Pick.
- **JX Mobile III finally has a launch date.** Management shared that Tencent (700 HK, BUY, TP: HKD400) and Kingsoft have mutually agreed to launch the long-awaited *JX Mobile III* before end-2Q19, likely in early June. We believe this should boost investor confidence, as well as earnings growth in FY19-20. Management expects this new game to do as well as *JX Mobile I*, which recorded CNY500m in monthly gross billings in the first month of its launch, then stabilised at CNY200m and, subsequently, CNY100m over the course of two years. With the launch date of this game finally firmed up, management guided for 30% online game revenue growth for FY19F.
- **Office software and cloud business to maintain high growth.** Managements expects to record 60% growth for its cloud business and 35-40% growth for its office software segment (WPS) in FY19. We like its WPS business, as it books very strong recurring revenue – since the product is now largely sold via the SaaS model. We think WPS product differentiates itself with integrated functions, artificial intelligence capabilities and value-added services, as well as user-friendly interfaces. The WPS business will also benefit from China encouraging and mandating the use of domestic software across governments units, state-owned enterprises and the private sector.
- **Financial outlook.** We raise our revenue forecast across all segments, and our earnings forecast rises by 7% and 5% for FY19 and FY20. We expect OPM to return to positive 9% from negative in FY18, driven by strong online game profits and narrowing losses from its cloud division. Earnings should grow to CNY1.2bn and CNY2.0bn in FY19-20F
- **Our TP implies FY19F P/E of 22x.** In our SOP calculation, in addition to the changes made to our earnings forecasts, we also lift the valuations for both games (to 10x FY19F P/E, from 8x) and the office software business (to 32x FY19F P/E, from 25x) on their strong fundamentals. We also applied a lower holding company discount of 30%, from 40%, to reflect the improved sentiment on the market.

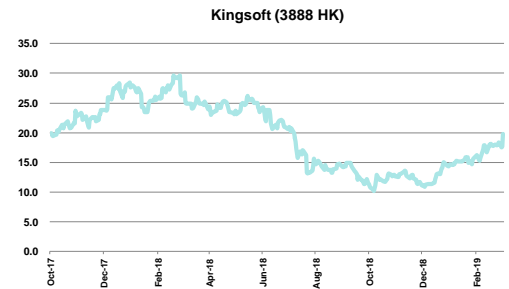
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**Share Performance (%)**

	YTD	1m	3m	6m	12m
Absolute	75.5	28.6	82.3	38.7	(26.1)
Relative	64.4	28.7	69.6	35.0	(19.4)
52-wk Price low/high (HKD)	10.1 – 27.6				



Source: Bloomberg

Forecasts and Valuations	Dec-17	Dec-18	Dec-19F	Dec-20F	Dec-21F
Total turnover (CNYm)	5,181	5,906	8,578	11,777	15,239
Recurring net profit (CNYm)	1213	747	1363	2186	2651
Recurring net profit growth (%)	27.2	(38.5)	82.5	60.4	21.3
Recurring P/E (x)	7.5	57.9	19.1	11.2	9.1
P/BV (x)	1.9	1.9	1.7	1.5	1.3
P/CF (x)	5.0	12.2	12.3	7.8	5.9
Dividend Yield (%)	0.5	0.6	0.6	0.6	0.6
EV/EBITDA (x)	12.5	N/M	13.6	7.2	5.4
ROE (%)	26.5	3.2	8.8	13.1	14.0
Net debt to equity (%)	(48.2)	(47.2)	(43.5)	(38.1)	(33.1)
Interest coverage (x)	7.2	N/M	1.8	4.1	5.4

Sources: Bloomberg, RHB, Company data

Figure 1: Changes to our forecasts

FYE Dec 31 (CNYm)	FY19F			FY20F		
	Original	New	Change	Original	New	Change
CNYm						
Online games	3,407.2	3,548.4	4.1%	4,814.7	4,615.2	-4.1%
Cloud	3,097.4	3,577.8	15.5%	4,346.4	5,187.7	19.4%
Office software and others	1,364.5	1,451.7	6.4%	1,877.3	1,974.2	5.2%
<b>Total revenue</b>	<b>7,869.0</b>	<b>8,577.9</b>	<b>9.0%</b>	<b>11,038.4</b>	<b>11,777.1</b>	<b>6.7%</b>
Cost of Revenue	(3,930.4)	(4,274.5)	8.8%	(5,099.1)	(5,440.4)	6.7%
<b>Gross profit</b>	<b>3,938.6</b>	<b>4,303.3</b>	<b>9.3%</b>	<b>5,939.3</b>	<b>6,336.7</b>	<b>6.7%</b>
Gross profit margin	50.1%	50.2%		53.8%	53.8%	
R&D costs	(2,196.7)	(2,385.0)	8.6%	(3,011.6)	(3,211.9)	6.6%
Selling expenses	(722.6)	(786.2)	8.8%	(960.6)	(1,024.6)	6.7%
Admin expenses	(507.0)	(552.3)	9.0%	(648.1)	(690.6)	6.6%
Other expenses	(16.0)	(17.4)	9.0%	(22.4)	(23.9)	6.7%
Share-based expenses	(221.0)	(223.1)	0.9%	(240.0)	(240.0)	0.0%
Other income	396.9	432.4	9.0%	556.8	594.0	6.7%
<b>Operating profit</b>	<b>672.2</b>	<b>771.8</b>	<b>14.8%</b>	<b>1,613.5</b>	<b>1,739.8</b>	<b>7.8%</b>
Operating margin	8.5%	9.0%		14.6%	14.8%	
Finance income	348.1	348.1	0.0%	407.2	407.2	0.0%
Finance costs	(425.0)	(425.0)	N/A	(427.2)	(427.2)	N/A
JC and associate	308.9	308.9	0.0%	323.0	323.0	0.0%
Gain on disposal/(Impairment)	-	-	N/A	-	-	N/A
PBT	904.1	1,003.8	<b>11.0%</b>	1,916.5	2,042.9	<b>6.6%</b>
Tax	(180.8)	(200.8)		(383.3)	(408.6)	
Effective tax rate	20.0%	20.0%		20.0%	20.0%	
<b>Profit from continuing operations</b>	<b>723.3</b>	<b>803.0</b>		<b>1,533.2</b>	<b>1,634.3</b>	
<b>Profit from a discontinued operation</b>	<b>-</b>	<b>-</b>		<b>-</b>	<b>-</b>	
Minority Interests	(380.0)	(380.0)		(372.0)	(372.0)	
<b>Net profit - reported</b>	<b>1,103.3</b>	<b>1,183.0</b>	<b>7.2%</b>	<b>1,905.2</b>	<b>2,006.3</b>	<b>5.3%</b>
NPM - reported (%)	14.0%	13.8%		17.3%	17.0%	

Source: Company data, RHB

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Figure 2: Annual P&amp;L

FYE Dec 31 (CNYm)	FY15	FY16	FY17	FY18F	FY19F	FY20F	FY21F
<b>Revenue</b>							
Online games	1,368.8	2,545.7	3,120.2	2,551.7	3,548.4	4,615.2	5,396.3
Cloud	271.5	737.2	1,332.5	2,217.5	3,577.8	5,187.7	7,281.7
Office software & others	392.4	550.7	728.6	1,137.0	1,451.7	1,974.2	2,560.7
<b>Total Revenue</b>	<b>2,032.7</b>	<b>3,833.5</b>	<b>5,181.3</b>	<b>5,906.2</b>	<b>8,577.9</b>	<b>11,777.1</b>	<b>15,238.7</b>
YoY	-39.3%	88.6%	35.2%	14.0%	45.2%	37.3%	29.4%
Cost of Revenue	(512.7)	(1,292.4)	(2,168.9)	(3,169.4)	(4,274.5)	(5,440.4)	(7,039.4)
<b>Gross Profit</b>	<b>1,520.0</b>	<b>2,541.1</b>	<b>3,012.4</b>	<b>2,736.8</b>	<b>4,303.3</b>	<b>6,336.7</b>	<b>8,199.3</b>
YoY	-44.9%	67.2%	18.5%	-9.1%	57.2%	47.3%	29.4%
Gross margins	74.8%	66.3%	58.1%	46.3%	50.2%	53.8%	53.8%
R&D costs, net of gov grants	(771.0)	(1,084.5)	(1,446.0)	(1,838.7)	(2,385.0)	(3,211.9)	(4,156.5)
Selling and distribution	(250.0)	(323.3)	(545.0)	(727.4)	(786.2)	(1,024.6)	(1,325.6)
Administrative expenses	(150.0)	(196.9)	(256.8)	(449.5)	(552.3)	(690.6)	(893.6)
Other operating costs	(31.0)	(7.7)	(9.5)	(89.5)	(17.4)	(23.9)	(30.9)
Share-based compensation	(52.0)	(54.9)	(235.2)	(211.9)	(223.1)	(240.0)	(240.0)
Other income	60.0	51.3	294.0	277.9	432.4	594.0	768.6
<b>Operating profit</b>	<b>326.0</b>	<b>925.1</b>	<b>813.9</b>	<b>(302.3)</b>	<b>771.8</b>	<b>1,739.8</b>	<b>2,321.2</b>
YoY	-36.5%	183.8%	-12.0%	-137.1%	-355.3%	125.4%	33.4%
Operating margins	16.0%	24.1%	15.7%	-5.1%	9.0%	14.8%	15.2%
Finance income	194.5	158.0	195.0	326.2	348.1	407.2	407.2
Finance costs	(78.1)	(107.1)	(112.4)	(327.0)	(425.0)	(427.2)	(427.2)
JC profit (losses)	(25.8)	101.3	121.0	49.9	71.5	80.0	80.0
Associate profit (losses)	(17.5)	(6.7)	51.1	373.8	237.4	243.0	243.0
Impairment	(64.9)	(1,152.2)	(156.5)	(145.6)	-	-	-
Gain on disposal	(10.6)	-	-	-	-	-	-
<b>PBT</b>	<b>323.7</b>	<b>(81.6)</b>	<b>912.1</b>	<b>(25.0)</b>	<b>1,003.8</b>	<b>2,042.9</b>	<b>2,624.3</b>
YoY	-66.3%	N/A	N/A	N/A	N/A	103.5%	28.5%
Tax	(140.0)	(177.2)	(133.8)	(140.2)	(200.8)	(408.6)	(524.9)
<b>Profit from continuing operations</b>	<b>183.7</b>	<b>(258.7)</b>	<b>778.3</b>	<b>(165.2)</b>	<b>803.0</b>	<b>1,634.3</b>	<b>2,099.4</b>
<b>Profit from a discontinued operation</b>	<b>158.1</b>	<b>(33.6)</b>	<b>294.1</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>
<b>Gain on deemed disposal of a subsidi:</b>	<b>-</b>	<b>-</b>	<b>2,224.3</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>
Minority Interests	(27.5)	(21.5)	94.8	(554.5)	(380.0)	(372.0)	(372.0)
<b>Net Profit</b>	<b>369.2</b>	<b>(270.7)</b>	<b>3,201.8</b>	<b>389.2</b>	<b>1,183.0</b>	<b>2,006.3</b>	<b>2,471.4</b>
YoY	-52.0%	-173.3%	-1282.7%	-87.8%	204.0%	69.6%	23.2%
Net profit margins	18.2%	-7.1%	61.8%	6.6%	13.8%	17.0%	16.2%

Source: RHB

Figure 3: SOP valuation

	FY19F net profit (CNYm)	Multiple(x)	NAV (CNYm)	NAV (HKDm)	KS's Stake	NAV (HKD)/share	Holding company discount	TP(HKD)
Games	1,313	10	13,129	15,361	67.00%	7.53		7.53
WPS	356	32	11,381	13,316	67.00%	6.53	30%	4.57
	<b>Ticker</b>		<b>Market Cap (USDm)</b>					
CMI	CMCM US		920	7,130	47%	2.45	30%	1.72
Xunlei	XNET US		240	1,860	10%	0.14	30%	0.10
21Vianet	VNET US		930	7,208	8%	0.42	30%	0.30
			<b>Valuation (Series D) (USDm)</b>					
Cloud			2,373	18,391	52%	6.94	30%	4.86
Net cash per share			5900.4	6,903	100%	5.05		5.05
<b>Total</b>						<b>28.64</b>		<b>24.12</b>

Source: RHB

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<b>Not Rated:</b>	Stock is not within regular research coverage

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