

24 October 2018

Technology | Software & Services

Kingsoft

Buy (Maintained)

Margin Pressures Persist But Long-Term Positive; BUY

Target Price: HKD24.73
 Price: HKD11.46
 Market Cap: USD2,001m
 Bloomberg Ticker: 3888 HK

Maintain BUY with new HKD24.73 TP, from HKD27.25, 116% upside. We expect Kingsoft's profit to be under pressure over a few quarters on:

1. Negative sequential growth of its online games due to the suspension of game licence issue and the aging of its existing games;
2. Re-accelerated growth from the lowest-margin cloud segment;
3. Slowdown of WPS growth YoY, due to a higher base.

We cut our FY18F-19F earnings by 44% and 17%. Kingsoft remains our sector Top Pick at this price level over a 1-year horizon, as we believe its three assets (WPS, cloud, and games) are of high quality and potential. We believe all the negatives have been priced in, and the launch of *JX III Mobile* and the A-share listing of WPS would make FY19 a good year.

Cloud growth re-accelerating; losses widening. Per our check with Kingsoft Cloud, we expect the division's revenue growth rate to return to the 60-70% level. This is mainly because Kingsoft has been more aggressive in the market, and has more support (direct and indirect) from Xiaomi Corp (1810 HK, NR) after the latter's recent IPO. With revenue growth re-accelerating, it is foreseeable for the cloud segment's losses (in terms of absolute amount) to be larger than last year, dragging down Kingsoft's overall GPM, OPM and NPM.

However, we are positive about this trend, as we believe market share is more important than the bottomline for the public cloud business in China at the current stage. Should Kingsoft Cloud continue to grow its topline strongly, it will survive as one of the key public cloud players in the China market and benefit from secular growth.

Online game business facing short-term pressure. As widely known, *JX III Mobile* (this game has already obtained the licence for monetisation) launch would be delayed to sometime in FY19, due to strategic concerns. Other games – including PC game updates – need to obtain licences before monetising, and the licence issue has been suspended indefinitely. Current mobile game line-up (includes old games such as *JX III PC* game and *JX I Mobile* – and the recently launched *YSYY*, and *JX World Mobile* games) is not performing very well, in our view, as user time is diverted by short-video apps and survival games.

WPS – positive catalyst. We recently visited the office software business (WPS) office in Zhuhai and came away positive. We believe WPS is on the right track to make its product more user-friendly and improve user efficiency, compared to competitors. Also, most recent user figures suggest strong future growth for membership fee revenue, while its monetisation strategy sounds reasonable and still has large potential. Please see our 2 Oct report [Positive Takeaways From WPS Site Visit; Maintain BUY](#) for more details.

3Q18 preview. We cut earnings by 44% and 17% for FY18F-19F mainly on online game segment weakness. We expect Kingsoft to have only 6.4% revenue growth and GAAP net profit of CNY82m in FY18 – revenue and profit is also to resume high growth in FY19. For 3Q18, we expect Kingsoft to post 8% YoY revenue growth, mainly driven by cloud and WPS, while its online game segment should see both YoY and QoQ decline. We estimate a net loss of CNY72m for 3Q18.

Maintain BUY with lower TP of HKD24.73, implying FY19F P/E of 24x. We view Kingsoft's three key segments as solid and promising, despite short-term pressure for the online game segment and financial numbers.

Forecasts and Valuations	Dec-16	Dec-17	Dec 18 F	Dec 19 F	Dec 20 F
Total turnover (CNYm)	3,834	5,181	5,514	7,869	11,038
Reported net profit (CNYm)	954	1,213	336	1,283	2,085
Recurring net profit (CNYm)	954	1,213	336	1,283	2,085
Recurring net profit growth (%)	73.4	27.2	(72.3)	281.8	62.5
Recurring EPS (CNY)	(0.21)	2.34	0.06	0.81	1.39
DPS (CNY)	0.09	0.09	0.10	0.10	0.10
Recurring P/E (x)	(47.91)	4.29	167.20	12.45	7.21
P/B (x)	0.74	0.74	0.75	0.69	0.61
Dividend Yield (%)	0.89	0.92	0.96	0.96	0.96
Return on average equity (%)	(3.4)	32.1	0.7	8.8	13.7
Net debt to equity (%)	(0.79)	(0.65)	(0.61)	(0.59)	(0.57)

Source: Company data, RHB

Share Data

Avg Daily Turnover (HKD/USD) 178m/23m
 52-wk Price low/high (HKD) 10.8 – 31.1
 Free Float (%) 55
 Shares outstanding (m) 1,299
 Estimated Return 116%

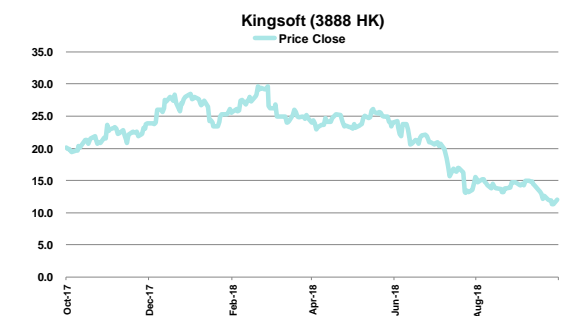
Shareholders (%)

Management 27.1
 Tencent 8.2

Share Performance (%)

	YTD	1m	3m	6m	12m
Absolute	(56.1)	(22.1)	(44.7)	(52.3)	(43.2)
Relative	(40.8)	(12.8)	(34.4)	(36.1)	(32.7)

Source: Bloomberg



Source: Bloomberg

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Figure 1: Forecast changes

FYE Dec 31 (CNYm)	FY18F			FY19F			FY20F		
	Original	New	Change	Original	New	Change	Original	New	Change
Online games	2,593.8	2,344.9	-9.6%	4,001.0	3,407.2	-14.8%	5,154.6	4,814.7	-6.6%
Cloud	2,048.1	2,125.2	3.8%	2,985.3	3,097.4	3.8%	4,187.2	4,346.4	3.8%
Office software and others	1,114.6	1,044.2	-6.3%	1,543.4	1,364.5	-11.6%	2,123.4	1,877.3	-11.6%
Total revenue	5,756.5	5,514.4	-4.2%	8,529.7	7,869.0	-7.7%	11,465.3	11,038.4	-3.7%
Cost of Revenue	(2,870.9)	(2,938.2)	2.3%	(3,765.0)	(3,930.4)	4.4%	(4,967.5)	(5,099.1)	2.6%
Gross profit	2,885.6	2,576.2	-10.7%	4,764.7	3,938.6	-17.3%	6,497.7	5,939.3	-8.6%
Gross profit margin	50.1%	46.7%		55.9%	50.1%		56.7%	53.8%	
R&D costs	(1,739.1)	(1,919.7)	10.4%	(2,161.8)	(2,196.7)	1.6%	(2,759.7)	(3,011.6)	9.1%
Selling expenses	(618.3)	(701.1)	13.4%	(754.5)	(722.6)	-4.2%	(990.7)	(960.6)	-3.0%
Admin expenses	(424.1)	(407.9)	-3.8%	(537.5)	(507.0)	-5.7%	(632.1)	(648.1)	2.5%
Other expenses	(7.7)	(7.2)	-5.6%	(17.3)	(16.0)	-7.7%	(23.2)	(22.4)	-3.7%
Share-based expenses	(204.6)	(199.5)	-2.5%	(225.8)	(221.0)	-2.1%	(240.0)	(240.0)	0.0%
Other income	254.7	246.5	-3.2%	430.3	396.9	-7.8%	578.4	556.8	-3.7%
Operating profit	146.6	(412.7)	-381.4%	1,498.2	672.2	-55.1%	2,430.4	1,613.5	-33.6%
Operating margin	2.5%	-7.5%		17.6%	8.5%		21.2%	14.6%	
Fair value gains	-	-	N/A	-	-	N/A	-	-	N/A
Finance income	311.6	311.6	0.0%	348.1	348.1	0.0%	407.2	407.2	0.0%
Finance costs	(350.1)	(350.1)	N/A	(425.0)	(425.0)	N/A	(427.2)	(427.2)	N/A
JC and associate	253.4	188.4	-25.7%	308.9	308.9	0.0%	323.0	323.0	0.0%
Gain on disposal/(Impairment)	(54.5)	(54.5)	N/A	-	-	N/A	-	-	N/A
PBT	307.1	(317.3)	-203.3%	1,730.1	904.1	-47.7%	2,733.4	1,916.5	-29.9%
Tax	(217.1)	(217.1)		(346.0)	(180.8)		(546.7)	(383.3)	
Effective tax rate	70.7%	-68.4%		20.0%	20.0%		20.0%	20.0%	
Profit from continuing operations	90.0	(534.4)		1,384.1	723.3		2,186.7	1,533.2	
Profit from a discontinued operation	-	-		-	-		-	-	
Minority Interests	(246.7)	(616.5)		20.0	(380.0)		75.0	(372.0)	
Net profit - reported	336.7	82.2	-75.6%	1,364.1	1,103.3	-19.1%	2,111.7	1,905.2	-9.8%
NPM - reported (%)	5.8%	1.5%		16.0%	14.0%		18.4%	17.3%	
Net profit - non-GAAP	595.7	336.1	-43.6%	1,544.1	1,283.3	-16.9%	2,291.7	2,085.2	-9.0%
NPM - non-GAAP (%)	10.3%	6.1%		18.1%	16.3%		20.0%	18.9%	

Source: RHB, Company data, Bloomberg

Figure 2: 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	2,344.9	3,407.2	4,814.7
Cloud	-	-	123.6	271.5	737.2	1,332.5	2,125.2	3,097.4	4,346.4
Office software	-	-	299.7	392.4	550.7	728.6	1,044.2	1,364.5	1,877.3
Total revenue	1,411.2	2,173.3	3,350.1	2,032.7	3,833.5	5,181.3	5,514.4	7,869.0	11,038.4
YoY	38.3%	54.0%	54.2%	-39.3%	88.6%	35.2%	6.4%	42.7%	40.3%
Cost of revenue	(186.9)	(297.1)	(589.7)	(512.7)	(1,292.4)	(2,168.9)	(2,938.2)	(3,930.4)	(5,099.1)
Gross profit	1,224.2	1,876.2	2,760.5	1,520.0	2,541.1	3,012.4	2,576.2	3,938.6	5,939.3
YoY	40.3%	53.3%	47.1%	-44.9%	67.2%	18.5%	-14.5%	52.9%	50.8%
Gross profit margin	86.8%	86.3%	82.4%	74.8%	66.3%	58.1%	46.7%	50.1%	53.8%
R&D costs	(385.4)	(596.5)	(956.1)	(771.0)	(1,084.5)	(1,446.0)	(1,919.7)	(2,196.7)	(3,011.6)
Selling expenses	(234.1)	(382.8)	(797.4)	(250.0)	(323.3)	(545.0)	(701.1)	(722.6)	(960.6)
Admin expenses	(148.0)	(192.2)	(297.4)	(150.0)	(196.9)	(256.8)	(407.9)	(507.0)	(648.1)
Other op costs	(23.0)	(7.3)	(29.9)	(31.0)	(7.7)	(9.5)	(7.2)	(16.0)	(22.4)
SBC	(48.5)	(61.4)	(201.9)	(52.0)	(54.9)	(235.2)	(199.5)	(221.0)	(240.0)
Other gains	28.6	45.9	35.8	60.0	51.3	294.0	246.5	396.9	556.8
Operating profit	413.9	681.9	513.6	326.0	925.1	813.9	(412.7)	672.2	1,613.5
YoY	24.9%	64.7%	-24.7%	-36.5%	183.8%	-12.0%	-150.7%	-262.9%	140.0%
Operating margin	29.3%	31.4%	15.3%	16.0%	24.1%	15.7%	-7.5%	8.5%	14.6%
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	188.4	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	(317.3)	904.1	1,916.5
Tax	(61.4)	(71.2)	(95.2)	(140.0)	(177.2)	(133.8)	(217.1)	(180.8)	(383.3)
Effective tax rate (%)	11.6%	8.6%	9.9%	43.3%	-217.2%	14.7%	-68.4%	20.0%	20.0%
Profit from continuing operations	-	-	-	183.7	(258.7)	778.3	(534.4)	723.3	1,533.2
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	(616.5)	(380.0)	(372.0)
Net profit - reported	432.6	670.7	768.8	369.2	(270.7)	3,201.8	82.2	1,103.3	1,905.2
YoY	33.2%	55.1%	14.6%	-52.0%	-173.3%	-1282.7%	-97.4%	1242.9%	72.7%
NPM - reported	30.7%	30.9%	22.9%	18.2%	-7.1%	61.8%	1.5%	14.0%	17.3%
Net Profit - non-GAAP	465.1	742.5	888.6	550.2	954.2	1,213.4	336.1	1,283.3	2,085.2
YoY	36.9%	59.7%	19.7%	-38.1%	73.4%	27.2%	-72.3%	281.8%	62.5%
NPM - non-GAAP	33.0%	34.2%	26.5%	27.1%	24.9%	23.4%	6.1%	16.3%	18.9%

Source: RHB, Company data

Figure 3: Kingsoft's SOP valuation table

	FY19F EPS (CNY)	FY19F P/E target (x)	KS's NAV (CNY) /share Stake	NAV (HKD)/share	Holding company discount	TP(HKD)	
Games	0.898	9	67.00%	5.41	6.06	6.06	
Office Software (Mainly WPS)	0.275	25	67.00%	4.60	5.15	3.09	
	Ticker	Market Cap (USDm)	NAV (USD) /share				
CMI	CMCM US	2,580	47%	0.45	3.46	40%	2.08
	Market Cap (USDm)		NAV (USD) /share				
Xunlei	XNET US	408	10%	0.03	0.24	40%	0.15
21Vianet	VNET US	1,040	8%	0.06	0.50	40%	0.30
	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					27.98		24.73

Source: Company data, RHB

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