

# KINGSOFT (3888.HK)

## Share price over-spiced, "Neutral" rating

Bloomberg | Reuters | POEMS

3888.HK | 3888.HK | 3888HK

Industry: Software & Services



Phillip Securities (Hong Kong) Ltd

Phillip Securities Research

31 October 2013

Rating: Neutral, CP: HKD19.38, TP: HKD19.04

### Company Profile

Kingsoft is a Chinese software and internet service company with main businesses including internet security, office software, entertainment software, cloud computing and on-line translation. Kingsoft provides a range of products and services such as Kingsoft Internet Security (KIS), Kingsoft PowerWord, WPS Office and online games.

### Investment rationales

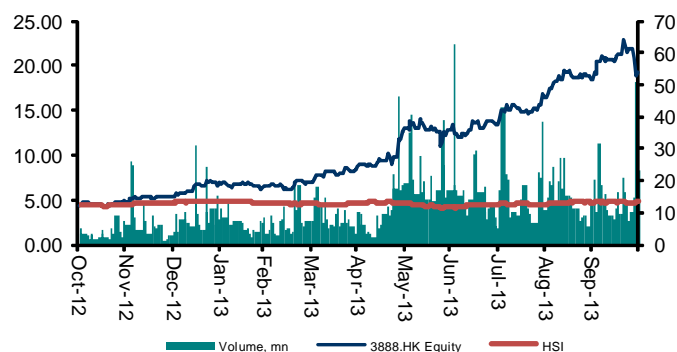
**Online games business review:** JX Online III and Ma La Jiang Hu remained as the two cash cows for the Company, management expected both of the games to achieve double-digit growth in revenue and APA in 2013 by adding item sales to improve gamer experiences.

The company has also launched 2 new MMO games, namely Jiutian Myth and Doomsday Dragon. With its strong R&D and distribution channel, we believed that these two games will be able to help the company capture the growth opportunities in the web gaming market.

**Application software business review:** There was a rapid growth in the application software business in 1H2013, which is primarily due to the revenue growth from online advertising and sustained strong performance of Kingsoft WPS Office. The Kingsoft Cloud for Wechat released helped the company capture a portion of the cloud computing and storage market and is expected to generate revenue for the Company. Moreover, introducing DST Global as strategic investor would also accelerate the development of the company in this business.

### KINGSOFT CORP

<b>Rating</b>	<b>3.00</b>	<b>Neutral</b>
- Previous Rating	N/A	Not Rated
<b>Target Price (HKD)</b>	<b>19.04</b>	
- Previous Target Price (HKD)	N/A	
Closing Price (HKD)	19.38	
Expected Capital Gains (%)	-1.8%	
Expected Dividend Yield (%)	0.6%	
<b>Expected Total Return (%)</b>	<b>-1.1%</b>	
Market Cap. (HKD mn)	22,867	
Enterprise Value (HKD mn)	19,818	
3M Average Daily T/O (mn)	15.5	
52 week range (HKD)	4.41 - 23.3	
Closing Price in 52 week range		



### Key Financial Summary

FYE	FY11	FY12	FY13E	FY14E
Revenue (HKD mn)	1,021	1,411	1,953	2,597
Net Profit, adj. (HKD mn)	337	450	575	791
EPS, adj. (HKD)	0.37	0.49	0.50	0.69
P/E (X), adj.	7.2	10.9	38.1	27.7
BVPS (HKD)	2.25	2.69	3.20	3.88
P/B (X)	1.2	2.0	6.0	4.9
DPS (HKD)	0.10	0.11	0.12	0.15
Div. Yield (%)	3.7%	2.1%	0.6%	0.8%

Source: Bloomberg, PSR est.

### Valuation Method

PE

### Analyst

Kevin Cheng

[kevincheng@phillip.com.hk](mailto:kevincheng@phillip.com.hk)

+852 2277 6626

**2013 interim results highlights:** Kingsoft's net profit came in at RMB341 mn, up 71.1% yoy in 1H13. Revenue climbed 55% yoy to RMB953 mn, the growth rate was the highest ever (vs. 24.4% in 1H12 and 4-year CAGR of 18.6%), driven by strong growth in revenue from application software. We want to highlight that revenue from application software surged 100.8% yoy to RMB407 mn and accounted for 42.7% of total revenue (vs. 33% in 1H12). It was mainly due to higher revenue from advertising of KIS. The monthly PC-based active user of KIS reached 155 mn and mobile product users of KIS increased to >100 mn at the end of July, 13, comparing to 41 mn at the end of Jan, 13. WPS office posted a satisfactory revenue growth of 13% yoy. We expect the high growth period to continue due to the increasing smartphone penetration rate in China and Chinese government striving to promote copyrighted software. Kingsoft has net cash of RMB2.71 bn as of June, 13, which help finding potential acquisition opportunities.

**R&D costs remain stable as percentage of revenue:**

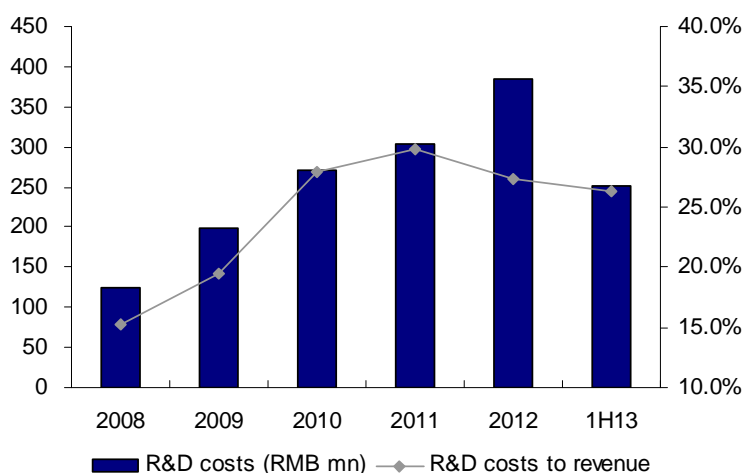
R&D costs for 1H13 rose 44% yoy to RMB251.4 mn, representing 26.4% to total revenue (vs. 28.3% in 1H12 and 27.3% in FY12). The R&D costs kept at 27-30% of total revenue since 2010. We expect the ratio remaining at this range to continue to invest in talents for mobile Internet and also the newly developing cloud business. The selling and distribution expenses were RMB139 mn in 1H13, up 95.5% yoy and equivalent to 14.6% of the total revenue (vs. 11.6% in 1H12 and 16.6% in FY12). The increase in the ratio was mainly due to promotion activities for online games and Cheetah Browser, a mobile application of KIS. We think the Kingsoft's costs are under control.

Fig.1 1H13 interim results highlight

(RMB mn)	2Q13	2Q12	YoY	1H13	1H12	YoY	Comments
<b>Revenue</b>	<b>496</b>	<b>322</b>	<b>53.7%</b>	<b>953</b>	<b>615</b>	<b>55.0%</b>	
-Online game	271	209	29.6%	537	400	34.4%	Mainly attributable to JX Online III and new games launched
-Application software	218	112	94.8%	407	203	100.8%	Driven by higher user traffic
-Others	7	2	303.0%	9	12	-28.4%	
<b>Gross profit</b>	<b>430</b>	<b>282</b>	<b>52.9%</b>	<b>826</b>	<b>525</b>	<b>57.4%</b>	Gross margin improved 2% to 87%
<b>PBT</b>	<b>186</b>	<b>134</b>	<b>39.1%</b>	<b>421</b>	<b>239</b>	<b>76.2%</b>	RMB47.5 mn from gain on disposal of a subsidiary
<b>Net profit</b>	<b>145</b>	<b>112</b>	<b>29.8%</b>	<b>341</b>	<b>199</b>	<b>71.1%</b>	
<b>EPS (HK\$ cents)</b>	<b>12.60</b>	<b>9.79</b>	<b>28.7%</b>	<b>29.67</b>	<b>17.48</b>	<b>69.7%</b>	
<b>DPS (HK\$ cents)</b>	<b>N/A</b>	<b>N/A</b>	<b>N/A</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0%</b>	No interim dividend
				<b>1H13</b>	<b>2012</b>		
<b>Total debt to equity</b>				<b>27.0%</b>	<b>27.0%</b>	<b>0.0%</b>	Kingsoft has net cash of RMB2.71 bn

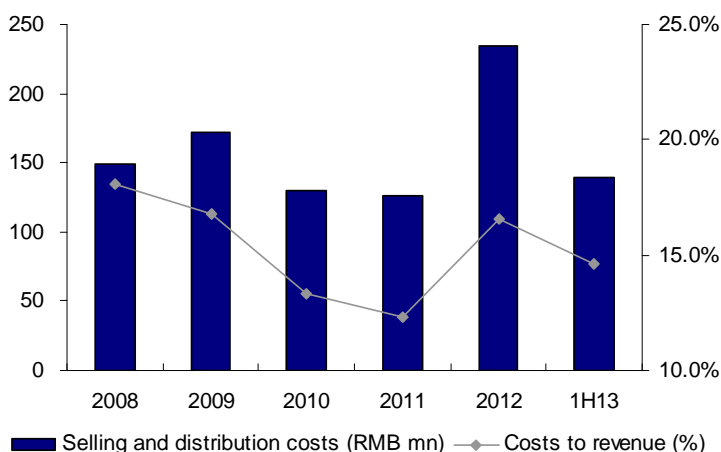
Source: PSR, Bloomberg

Fig.2 R&D costs and % to revenue



Source: PSR, Bloomberg

Fig.3 Selling and distribution costs and % to revenue



Source: PSR, Bloomberg

## Valuation

We give the target price of HK\$19.04 based on a sum of parts PE valuation. By applying 8x PE on online game business and 38x PE on application software due to higher growth in the business.

Fig.4 Valuation

(HKD mn)	2014E revenue	2014E earnings	Target 2014E PER	Est. fair value	Est. fair value per share (HKD)
Online Games	1,577	635	8	5,080	4.28
Application Software	1,709	367	38	13,946	11.76
2014E cash per share					3.00
Price target (HKD)					<b>19.04</b>

Source: PSR

## Major risks

- The company spent a large proportion of its expense in R&D. This is an important factor for stronger revenue growth, but the impact on financial benefit might not be as significant compared to resources put into the area. In case of a sudden increase in R&D expenses which was not matched with a corresponding reward in revenue, the company will suffer a loss.
- The growth trend in the share price recently is slightly too rapid. In case of any economic downturn, the stock might suffer a strong downward pressure.

### Financial Status

FYE	FY11	FY12	FY13E	FY14E
<b>Valuation Ratios</b>				
P/E (X), reported	7.5	11.3	38.1	27.7
P/E (X), adj.	7.2	10.9	38.1	27.7
P/B (X)	1.2	2.0	6.0	4.9
Dividend Yield (%)	3.7%	2.1%	0.6%	0.8%
Dividend payout ratio (%)	26.7%	22.3%	24.0%	21.8%
<b>Per share data (HKD)</b>				
EPS, reported	0.36	0.47	0.50	0.69
EPS, adj.	0.37	0.49	0.50	0.69
DPS	0.10	0.11	0.12	0.15
BVPS	2.25	2.69	3.20	3.88
<b>Growth &amp; Margins (%)</b>				
<b>Growth</b>				
Revenue	5.1%	38.3%	38.4%	33.0%
EBITDA	5.3%	27.1%	37.6%	33.0%
Net Income, adj.	-12.2%	33.7%	27.7%	37.6%
<b>Margins</b>				
EBITDA margin	38.3%	35.2%	47.0%	48.0%
EBIT margin	29.2%	28.9%	29.4%	36.0%
Net Profit margin	33.0%	31.9%	29.4%	30.5%
<b>Key Ratios</b>				
ROE(%)	16.7%	19.4%	45.7%	21.0%
ROA (%)	12.3%	13.5%	31.6%	13.0%
Net Gearing (%)	Net cash	Net cash	Net cash	Net cash
<b>Income Statement (RMB mn)</b>				
<b>Revenue</b>	<b>1,021</b>	<b>1,411</b>	<b>1,953</b>	<b>2,597</b>
<b>EBITDA</b>	<b>391</b>	<b>497</b>	<b>684</b>	<b>909</b>
Depreciation & amortisation	(93)	(89)	(110)	(135)
<b>EBIT</b>	<b>298</b>	<b>408</b>	<b>574</b>	<b>774</b>
Net finance (expense)/income	62	89	156	200
Associates & JVs	(6)	9	0	0
Other items	31	22	0	0
<b>Profit before tax</b>	<b>385</b>	<b>528</b>	<b>730</b>	<b>974</b>
Taxation	(50)	(61)	(70)	(90)
<b>Profit after tax</b>	<b>335</b>	<b>466</b>	<b>660</b>	<b>884</b>
Non-controlling interest	(10)	(34)	(85)	(93)
<b>Net income, reported</b>	<b>325</b>	<b>433</b>	<b>575</b>	<b>791</b>
<b>Net income, adj</b>	<b>337</b>	<b>450</b>	<b>575</b>	<b>791</b>

Source: PSR est.

**PHILLIP RESEARCH STOCK SELECTION SYSTEMS**

Total Return	Recommendation	Rating	Remarks
>+20%	Buy	1	>20% upside from the current price
+5% to +20%	Accumulate	2	+5% to +20% upside from the current price
-5% to +5%	Neutral	3	Trade within $\pm$ 5% from the current price
-5% to -20%	Reduce	4	-5% to -20% downside from the current price
<-20%	Sell	5	>20% downside from the current price

We do not base our recommendations entirely on the above quantitative return bands. We consider qualitative factors like (but not limited to) a stock's risk reward ratio, market sentiment, recent rate of share price appreciation, presence or absence of stock price catalysts, and speculative undertones surrounding the stock, before making a recommendation.

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**Contact Information (Regional Member Companies)**

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**SINGAPORE**

**Phillip Securities Pte Ltd**  
Raffles City Tower  
250, North Bridge Road #06-00  
Singapore 179101  
Tel : (65) 6533 6001  
Fax : (65) 6535 6631  
Website: [www.poems.com.sg](http://www.poems.com.sg)

**HONG KONG**

**Phillip Securities (HK) Ltd**  
Exchange Participant of the Stock Exchange of Hong Kong  
11/F United Centre 95 Queensway  
Hong Kong  
Tel (852) 22776600  
Fax (852) 28685307  
Websites: [www.phillip.com.hk](http://www.phillip.com.hk)

**INDONESIA**

**PT Phillip Securities Indonesia**  
ANZ Tower Level 23B,  
Jl Jend Sudirman Kav 33A  
Jakarta 10220 – Indonesia  
Tel (62-21) 57900800  
Fax (62-21) 57900809  
Website: [www.phillip.co.id](http://www.phillip.co.id)

**THAILAND**

**Phillip Securities (Thailand) Public Co. Ltd**  
15th Floor, Vorawat Building,  
849 Silom Road, Silom, Bangrak,  
Bangkok 10500 Thailand  
Tel (66-2) 6351700 / 22680999  
Fax (66-2) 22680921  
Website [www.phillip.co.th](http://www.phillip.co.th)

**UNITED KINGDOM**

**King & Shaxson Capital Limited**  
6th Floor, Candlewick House,  
120 Cannon Street,  
London, EC4N 6AS  
Tel (44-20) 7426 5950  
Fax (44-20) 7626 1757  
Website: [www.kingandshaxson.com](http://www.kingandshaxson.com)

**AUSTRALIA**

**PhillipCapital Australia**  
Level 37, 530 Collins Street,  
Melbourne, Victoria 3000, Australia  
Tel (613) 96298380  
Fax (613) 96148309  
Website: [www.phillipcapital.com.au](http://www.phillipcapital.com.au)

**MALAYSIA**

**Phillip Capital Management Sdn Bhd**  
B-3-6 Block B Level 3 Megan Avenue II,  
No. 12, Jalan Yap Kwan Seng, 50450  
Kuala Lumpur  
Tel (603) 21628841  
Fax (603) 21665099  
Website: [www.poems.com.my](http://www.poems.com.my)

**JAPAN**

**PhillipCapital Japan K.K.**  
Nagata-cho Bldg.,  
8F, 2-4-3 Nagata-cho,  
Chiyoda-ku, Tokyo 100-0014  
Tel (81-3) 35953631  
Fax (81-3) 35953630  
Website: [www.phillip.co.jp](http://www.phillip.co.jp)

**CHINA**

**Phillip Financial Advisory (Shanghai) Co. Ltd**  
No 550 Yan An East Road,  
Ocean Tower Unit 2318,  
Postal code 200001  
Tel (86-21) 51699200  
Fax (86-21) 63512940  
Website: [www.phillip.com.cn](http://www.phillip.com.cn)

**FRANCE**

**King & Shaxson Capital Limited**  
3rd Floor, 35 Rue de la Bienfaisance 75008  
Paris France  
Tel (33-1) 45633100  
Fax (33-1) 45636017  
Website: [www.kingandshaxson.com](http://www.kingandshaxson.com)

**UNITED STATES**

**Phillip Futures Inc**  
141 W Jackson Blvd Ste 3050  
The Chicago Board of Trade Building  
Chicago, IL 60604 USA  
Tel +1.312.356.9000  
Fax +1.312.356.9005