KINGSOFT CORP LTD (3888.HK)

Concern on the sustainability of high growth in Internet business

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Industry: Software & Services

Phillip Securities (Hong Kong) Ltd

Phillip Securities Research

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Rating: Neutral, CP: HKD22.00, TP: HKD21.42

Company Profile

Kingsoft is a leading Internet-based software companies in China. It provides online games, Internet security software, office software and cloud services. Group has in-house software development team, and provides application software services through their own Internet platform. In online games they have the famous "JX series" as the flagship product for many years and attracted millions paying players. For Internet security and office software, there are Kingsoft Anti-Virus and WPS Office. Products are mainly sold in the mainland China, but also exported to Hong Kong, Macao, Taiwan and Southeast Asian countries.

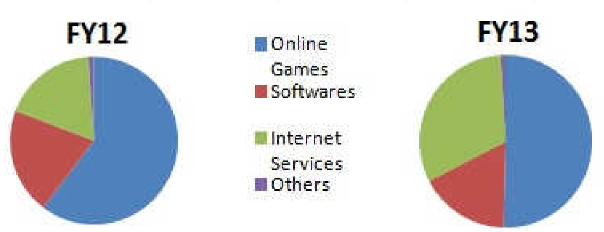
Financial Highlights

The revenue rose by 54% yoy to RMB 2.173 billion (as below) for FY13, which revenues from online games increased by 28.7% to $1.096 billion and from application software surged 94% yoy to $1.056 billion. Gross profit increased by 53.3% to $1.876 billion, the gross profit margin was about the same of 86% as before. Operating profit was $682 million, an increase of 65% while profit attributable to shareholders was $671 million, an increase of 55%. Final dividend was HK$ 0.12. Kingsoft's performance for last year was excellent, especially in the Internet services and software, both achieved significant increase in sales.

Changes in product mix, the Internet service will become the main source of revenue

Compared to the previous financial year, the product mix for FY13 has changed significantly. In FY12, revenue from online game was a major source of revenue for the company, accounted for 60%of the total revenue; followed by the software business, 20% of total revenue; Internet services, including Internet security software, online platform and mobile applications, consist of only 18% of the total revenue. However in FY13, revenue from online game was $1.096 billion, accounted for 50% of total revenue; software revenue as $370 million, 17% of the total while revenue from Internet service surged to $686 million, as of 32% of total revenue.

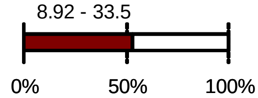
Fig 1 Product mix of Kingsoft

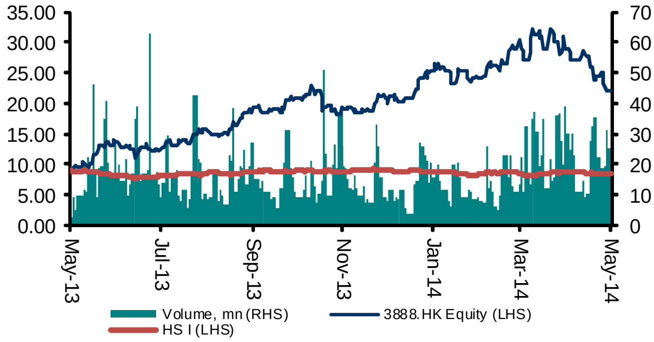


Source: Company reports

It is expected in the next few years, the revenue from Internet service will continue to rise. The proportion will increase to 45% to total revenue in FY14, which will become the largest source of income. In FY16, there will be a further rise to 53%.

KINGSOFT CORP		
Rating	**3.00**	**Neutral**
- Previous Rating	*N/A*	*Not Rated*
Target Price (HKD)	**21.42**	
- Previous Target Price (HKD)	*N/A*	
Closing Price (HKD)	22.00	
Expected Capital Gains (%)	-2.6%	
Expected Dividend Yield (%)	0.6%	
Expected Total Return (%)	**-2.0%**	
Market Cap. (HKD mn)	26,029	
Enterprise Value (HKD mn)	22,143	
3M Average Daily T/O (mn)	19.3	
52 w eek range (HKD)	8.92 - 33.5	
Closing Price in 52 w eek range		





Key Financial Summary

FYE MAR	**FY13**	**FY14E**	**FY15E**	**FY16E**
Revenue (RMB mn)	2,173	2,932	4,008	4690
Net Profit, reported (RMB mn)	670	848	1,322	1466
EPS, adj. (HKD cents)	72	89.00	139.00	154.00
P/E (X)	30.5	24.7	15.9	14.3
P/B (X)	5.3	4.5	3.5	2.8
DPS (RMB cents)	0.1	0.1	0.1	0.15
Div Yield (%)	0.5%	0.6%	0.6%	0.7%

Source: Bloomberg, PSR est.

Valuation Method

PE

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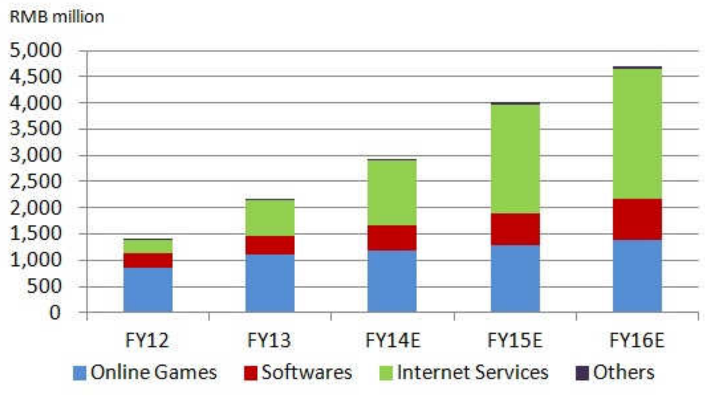
Fig 2 Revenue estimate



Source: PSR, Company reports

Table 1 Revenue estimate

	FY12	FY13	FY14E	FY15E	FY16E
Online Games	851	1,096	1,195	1,291	1,381
Softwares	289	370	474	607	777
Internet Services	256	686	1,235	2,075	2,490
Others	16	22	28	35	42
Total Revenue	1,411	2,173	2,932	4,008	4,690

Source: PSR, Company reports

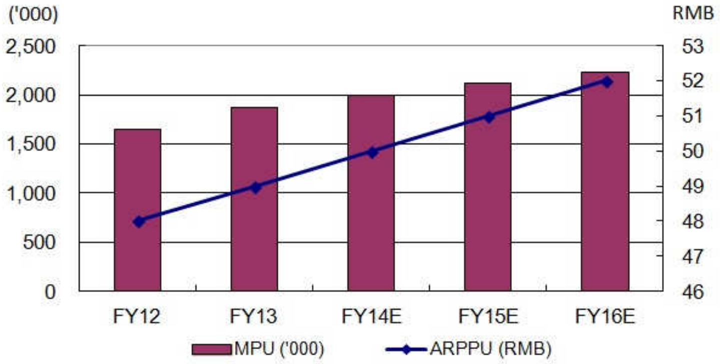
One thing to mention, the revenue from Internet service in FY13 was $686 million, a substantial increase of 168% from $256 million. But this increase may due to the rapid growth in online sales for "Double Eleven Shopping Festival" (Single Festival), and increase revenue from KIS game platform. Therefore it is expected
1) Despite that there will still be impressive sales volume in this year's Shopping Festival, the growth is difficult to compare with last year; 2) The growth will mainly achieved by KIS game platform and its mobile Internet applications.

And the sales of office software, benefited by the PRC government's policy of protecting legitimate software which required to use the legitimate software in the public organizations. This stimulated the sales of WPS Office software and software business is expected to have nearly 30% annual growth in the coming years.

Steady growth in the online game business, good cost controls

For FY13, company's online game business recorded 28.7% growth, mainly due to the ten consecutive quarters growth of its flagship game "JX 3". In the fourth quarter of FY13, "JX 3" had published its additional patch, led to its daily average peak concurrent users (DAU) increased by 3% qoq to 630 thousands, but a slightly decline yoy. As of the end of FY13, the average monthly paid users (MPU) was 1.87 million, an increase of 13% yoy and 4% qoq. However, compared to peak 2,000,000 paying users in summer, it could not fully regain the lost ground. The average monthly revenue of paying users (ARPPU) slightly increased 2% to RMB 49. It was expected the future online gaming revenue will grow slowly, with an average annual growth rate ranging from 7% to 9%.

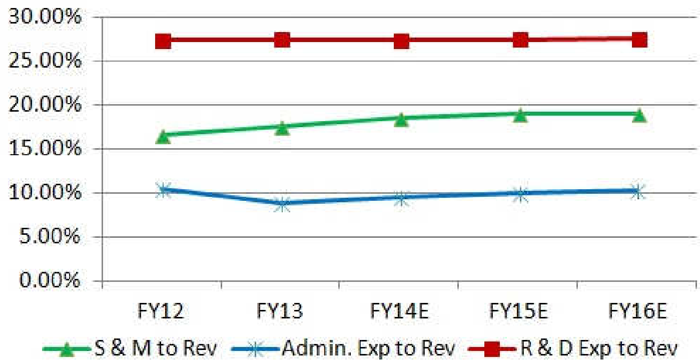
Fig 3 MPU & ARPPU estimate



Source: PSR, Company reports

Despite the rapid growth in total revenue, expense to revenue did not increase significantly. Research and development expenses rose 55% to $596 million, sales and marketing expenses increased by 64% to $383 million and administrative expenses increased by 30% to 192 million. The overall expense to revenue rose only according to its operating income, reflecting the company's good cost control.

Fig 4 Costs as percentage of revenue estimates



Source: PSR, Company reports

Spin-off of Cheetah Mobile Inc, focus on Internet and mobile services

Kingsoft spin-off its former Kingsoft Internet Software (KIS) Holdings Ltd, renamed to Cheetah Mobile Inc. (CMI) and applied for the initial public offering of American Depositary Shares in NYSE, which was priced at US$ 14 and started to trade on board on May 8. According to company reports, CMI shall not engage in games and software research and development, or operation of its self developed games. CMI will mainly engage in information security software, web browser. Its main mission is to develop and operate mobile games and applications, and provides online advertising services and Internet value-added services. After the spin-off of CMI, Kingsoft's voting power on CMI remains unchanged, but the stake will decrease 7.1% to 47%. Therefore, the profit attributable to non-controlling interests will increase, resulting to profit attributable to Kingsoft's to reduce accordingly.

In addition, Kingsoft has also announced its subscription of 31.94 million of Xunlei Series E preferred shares, representing 9.98% of the total shares that had been issued. These preferred shares were convertible at any time to Xunlei Series ordinary shares. The subscription was to strengthen Kingsoft's Internet services penetration rate.

Valuation

We believe that the market valuation of over 40x P/E of Kingsoft at the beginning of this year is indeed too high. Despite of supportive government policy for its software business and the high growth in Internet business, the revenue growth of Internet service in FY13, in partly due to a substantial increase in online sales for the Single Festival last year. Besides, the market estimate on Kingsoft's mobile Internet revenue was just over-optimistic. Given the recent market volatility, the out-performing stock last year dropped significantly recently, and investors begin to pay attention to the high valuation of IT stocks. After re-examine the valuation, we estimate the 6-12 months target price for Kingsoft to be HK $ 21.42, which is 24 times of FY14 forecasted earnings and give rating as "neutral". This is calculated by the valuation HK $ 17.63 for operation and HK $ 3.79 for cash.

Table 1 Revenue estimate

	2014E revenue	HKD	EPS	PE	Valuation
Online games	339.1	420	0.355	14x	4.97
Internet services	381.6	473	0.400	25x	10
Software	127.2	157	0.133	20x	2.66
Total	848				17.63

*conversion rate 1.24 HKD: RMB

Source: PSR

However, in the long run, HK $ 21.42 is only equaled 15.4 times and 14 times of the forecasted earnings in FY15 and FY16 respectively. It is expected the long-term valuation will rise back to the around 20 to 25 times.

Potential risks

Revenue from online games decrease
Internet business growth slows down
After the spin-off Cheetah Mobile, revenue affected by reduction in stake
Costs and expenses increase more than expected

Financial Status

	FY12	FY13	FY14E	FY15E	FY16E
Valuation Ratios					
P/E (X), reported	46.89	30.54	24.74	15.88	14.32
P/B (X)	7.6	5.3	4.5	3.5	2.8
EV/EBITDA (X)	53.5	32.5	23.8	15.1	13.3
Dividend Yield (%)	0.5%	0.5%	0.6%	0.6%	0.7%
Per share data (HKD)					
EPS, reported	0.47	0.72	0.89	1.39	1.54
DPS	0.11	0.12	0.13	0.14	0.15
BVPS	2.90	4.12	4.90	6.29	7.83
Outstanding Shares (basic, mn)	1,142.83	1,154.13	1,183.15	1,183.15	1,183.15
Outstanding Shares (diluted, mn)	1,142.83	1,154.13	1,183.15	1,183.15	1,183.15
Growth & Margins (%)					
Growth					
Revenue	N/A	54.0%	34.9%	36.7%	17.0%
EBIT	N/A	64.7%	36.4%	57.5%	14.0%
Margins					
Gross profit margin	86.8%	86.3%	86.2%	86.2%	86.2%
EBT margin	37.4%	38.0%	36.0%	39.9%	38.7%
Net Profit Margin	30.6%	30.9%	28.9%	33.0%	31.3%
Income Statement (RMB mn)	**FY12**	**FY13**	**FY14E**	**FY15E**	**FY16E**
Revenue	**1,411**	**2,173**	**2,932**	**4,008**	**4,690**
Cost of revenue	**(187)**	**(297)**	**(405)**	**(553)**	**(647)**
Gross profit	**1,224**	**1,876**	**2,527**	**3,455**	**4,043**
Selling & Marketing expenses	**(234)**	**(383)**	**(517)**	**(649)**	**(770)**
Administrative expenses	**(148)**	**(192)**	**(266)**	**(342)**	**(417)**
R & D expenses	**(385)**	**(596)**	**(766)**	**(937)**	**(1,114)**
Other income	**29**	**46**	**32**	**35**	**40**
Other expense	**(71)**	**(69)**	**(81)**	**(98)**	**(113)**
Operating profit	**414**	**682**	**929**	**1,464**	**1,669**
Non operating income (expense)	**16**	**37**	**10**	**10**	**10**
Net finance income (expense)	**98**	**106**	**115**	**124**	**134**
EBT	**528**	**825**	**1,054**	**1,598**	**1,813**
Taxation	**(61)**	**(71)**	**(94)**	**(120)**	**(139)**
Profit After Tax	**466**	**754**	**960**	**1,478**	**1,674**
Minority interest	**(34)**	**(83)**	**(112)**	**(156)**	**(208)**
Net Profit	**432**	**670**	**848**	**1,322**	**1,466**
EPS	**0.378**	**0.581**	**0.717**	**1.117**	**1.239**

Source: Company, PSR

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 ± 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 profile, market sentiment, recent rate of share price appreciation, presence or absence of stock price catalysts, and speculative undertones surrounding the stock, before making our final recommendation

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