

3 July 2014

INSPUR INT'L (596.HK)

Surged costs and expenses cause net loss in the coming future

HONG KONG | SOFTWARE | COMPANY ANALYSIS

Rating: **Neutral**

- Inspur's turnover for 2013 increased 12% to HK\$ 1.3 Bn while gross profit just slightly went up 4.7% yoy, with gross profit margin dropped 2.4% yoy to 34.1%.
- Operating loss amounted to HK\$ 150.9 Mn, while profit attributable to parent was HK\$ 116 Mn after calculating the disposal gain from discontinued operation HK\$ 268.2 Mn.
- In fact, the revenue gained from core operation was not enough to cover the cost and expenses. More disappointing estimate showed that the loss would likely last for several years even revenue continued to grow on software development.
- We conservatively give Inspur an initial rating of "Neutral" with target price HK\$ 1.56, slightly lower than the current price.

Financial Highlights

Inspur's 2013 turnover increased 12% yoy to HK\$ 1.3 Bn, in which revenue from software development rose 31.7% yoy to HK\$ 648 Mn; outsourcing amounted to HK\$ 194.3 Mn, up 3.1% yoy. and sales of IT peripherals and software dropped 4.6% yoy to HK\$ 458.7 Mn. The cost of sale rose 16.2% yoy to HK\$ 857.2 Mn, causing the gross profit just slightly went up 4.7% yoy to HK\$ 443.8 Mn, with gross profit margin dropped 2.4% yoy to 34.1%. Operating loss amounted to HK\$ 150.9 Mn, while profit attributable to parent was HK\$ 116 Mn after calculating the disposal gain from discontinued operation HK\$ 268.2 Mn.

How we view this

Based on the company's adjusted performance summary for the recent years (Fig 3), turnover increased gradually but the expenses surged during the 5 years, which led to the sharply slumped of the company's profit. In fact, the revenue gained from core operation was not enough to cover the cost and expenses. Profit in 2013 is only due to the disposal of operation. More disappointing estimate showed that the loss would likely last for several years even revenue continued to grow on the software development. Although the company is actively invested in the R&D and claimed to transform its focus to the cloud business since 2011, the result was not as significant as forecasted, while the investment expenditures continued to go up.

Investment Action

As a result, based on the negative historical results and future outlook, we expected the company can hardly generate positive profit in the coming years. Although there is news on the replacing of IBM server business and the company confirmed to employed former IBM staff recently. It is still a doubt that any realistic future revenue would earn. Therefore, we just conservatively give Inspur an initial rating of "Neutral" with target price HK\$ 1.56, slightly lower than the current price.

Key Financial Summary

FYE Dec	FY12	FY13	FY14E	FY15E	FY16E
Revenue (HKD mn)	1,162	1,301	1,480	1,681	1,884
Net Profit (HKD mn)	(93)	118	(172)	(222)	(273)
EPS (HKD)	(0.11)	0.14	(0.19)	(0.25)	(0.30)
P/E (X)	(14.9)	11.9	(8.6)	(6.7)	(5.4)
BVPS (HKD)	2.02	2.27	1.96	1.65	1.28
P/B (X)	0.8	0.7	0.8	1.0	1.3
DPS (HKD)	0.03	0.03	0.03	0.03	0.03
Div. Yield (%)	1.8%	1.8%	1.8%	1.8%	1.8%

Source: Company reports, PSHK est.

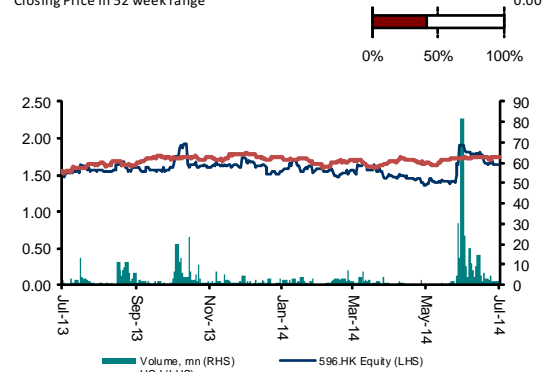
Target Price (HKD)	1.56
Forecast Dividend (HKD)	0.03
Closing Price (HKD)	1.65
Potential Upside	-3.6%

Company Description

Inspur provides integrated IT services including software development and sales, embedded systems and IT outsourcing. The company is focused on government departments, state and large enterprises and its customers are located over 40 regions.

Company Data

Raw Beta (Past 2yrs weekly data)	N/A
Market Cap. (HKD bn)	1,488
Enterprise Value (HKD mn)	482.55
52 week range (HKD)	1.36-2.05
Closing Price in 52 week range	0.00



Major Shareholders

1. Inspur Electronics (HK) Ltd	32.11%
2. Wang Yukun	7.18%

Valuation Method

PE

Analyst

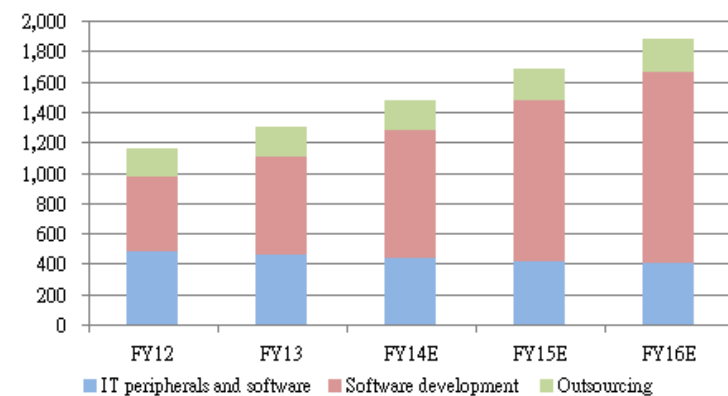
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Revenue from software development remains the growth momentum

The revenue from software development rose 31.7% yoy to HK\$ 648 Mn; outsourcing amounted to HK\$ 194.3 Mn, up 3.1% yoy. and sales of IT peripherals and software dropped 4.6% yoy to HK\$ 458.7 Mn. It is forecasted that the growth on software development, included the cloud business can reach a 20%-30% yearly growth in the coming few years. According to company's previous financial statements, the outsourcing business expanded rapidly in 2012 with over 50% growth, but the growth rate suddenly dropped to 3.1% this year implied unstable or negative growth may occur in the future.

Fig 1 Revenue Mix estimate

(HKD Mn)



Source: Company reports

Revenue from continuing operation is not enough to cover the cost and expenses

The cost of sale rose 16.2%yoy to HK\$ 857.2 Mn, causing the gross profit just slightly went up 4.7% yoy to HK\$ 443.8 Mn, with gross profit margin dropped 2.4% yoy to 34.1%. There is operating loss of HK\$ 150.9 Mn for the year, but HK\$ 116 Mn profit attributable to parent since the disposal gain from discontinued operation HK\$ 268.2 Mn was calculating.

The table below is the reported and estimated revenue and expenditures, which showed that there is still a big negative gap between two.

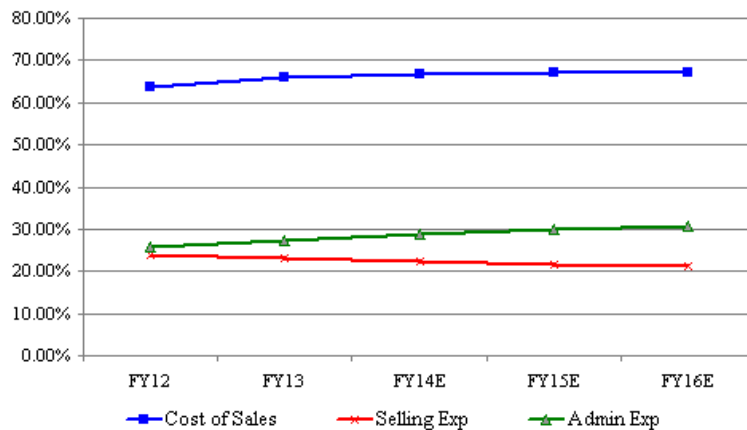
Table 1 Revenue and cost projection

	FY12	FY13	FY14E	FY15E	FY16E
Revenue	1,162	1,301	1,480	1,681	1,884
Cost of Sales	738	857	987	1,131	1,262
Selling	276	299	329	362	398
Admin	301	357	428	505	581
	1,314	1,513	1,744	1,998	2,241

Source: PSR, Company report

Cost of sales is believed to rise slightly to around 67%. The forecasted growth rate in selling expenses will maintain at around 10%, while 15%-20% in admin expenses.

Fig 2 Costs as percentage of revenue estimates



Source: PSR, Company report

Negative historical performance due to surge in cost and expenses

Based on the company's adjusted performance summary for 5 years (Fig 3), turnover increased gradually in the recent 3 years but the attributable profit sharply slumped which implied the expenses surged during the years, and the profit is only resulted from the disposal of operation. Although the company claimed to invest heavily in R&D and started to transform its focus to the cloud business since 2011, we estimate that the loss would likely last for several years even revenue continued to grow.

Valuation

Based on the negative historical results and future outlook, we expected the company can hardly generate positive profit in the coming years. Although there is news on the replacing of IBM server business and the company confirmed to employed former IBM staff recently. It is still a doubt that any realistic future revenue would earn before heavily investment. Therefore, we just conservatively give Inspur an initial rating of "Neutral" with target price HK\$ 1.56, slightly lower than the current price. The target is calculated based on cash in hand plus the entrusted loan per share.

Potential Risks

The growth on cloud business slow down;
The cost structure worsen;

Fig 3 Performance summary for 5 years

		For the year ended 31 December 截至十二月三十一日止年度				
		2009 二零零九年 HK\$'000 千港元 (restated) (經重列)	2010 二零一零年 HK\$'000 千港元 (restated) (經重列)	2011 二零一一年 HK\$'000 千港元 (restated) (經重列)	2012 二零一二年 HK\$'000 千港元 (restated) (經重列)	2013 二零一三年 HK\$'000 千港元
RESULTS	業績					
Continuing operation	持續經營業務					
Revenue	收入	1,483,446	1,418,833	1,258,139	1,161,560	1,300,980
Profit (loss) before taxation	除稅前溢利(虧損)	247,542	144,819	(2,417)	(154,023)	(150,942)
Taxation	稅項	(28,595)	(13,548)	(8,131)	(4,189)	(1,282)
Profit (loss) for the year from continuing operation	來自持續經營業務的 年內溢利(虧損)	218,947	131,271	(10,548)	(158,212)	(152,224)
Discontinued operation	已終止業務					
Profit for the year from discontinued operation	來自已終止業務 的年內溢利	24,613	46,263	58,708	58,843	268,183
Profit (loss) for the year	年內溢利(虧損)	243,560	177,534	48,160	(99,369)	115,959
Profit (loss) for the year attributable to:	應佔年內 溢利(虧損):					
Owners of the Company	本公司擁有人	254,501	177,972	50,408	(93,319)	117,696
Non-controlling interests	非控股權益	(1,970)	(438)	(2,248)	(6,050)	(1,737)
		252,531	177,534	48,160	(99,369)	115,959

Source: Company report

	FY12	FY13	FY14E	FY15E	FY16E
Valuation Ratios					
P/E (X)	(14.9)	11.9	(8.6)	(6.7)	(5.4)
P/B (X)	0.8	0.7	0.8	1.0	1.3
EV/EBITDA (X)	(3.0)	(3.7)	(2.9)	(2.3)	(1.8)
Dividend Yield (%)	1.8%	1.8%	1.8%	1.8%	1.8%
Per share data (HKD)					
EPS	(0.111)	0.138	(0.191)	(0.246)	(0.303)
DPS	0.030	0.030	0.030	0.030	0.030
BVPS	2.023	2.274	1.959	1.654	1.278
Outstanding Shares (basic, mn)	841.53	852.40	901.54	901.54	901.54
Growth & Margins (%)					
Growth					
Revenue	#DIV/0!	12.0%	13.8%	13.6%	12.1%
EBIT	#DIV/0!	-18.9%	25.3%	30.5%	24.8%
Margins					
Gross profit margin	36.5%	34.1%	33.3%	32.7%	33.0%
EBT margin	-13.3%	-11.6%	-12.2%	-13.7%	-15.1%
Net Profit Margin	-8.0%	9.0%	-11.6%	-13.2%	-14.5%
Key Ratios					
ROE (%)	-6.8%	7.5%	-12.1%	-18.5%	-29.4%
ROA (%)	-2.3%	3.0%	-4.6%	-6.3%	-8.4%
Income Statement (RMB mn)					
Revenue	1,162	1,301	1,480	1,681	1,884
Cost of revenue	(738)	(857)	(987)	(1,131)	(1,262)
Gross profit	424	444	493	550	622
Selling & Marketing expenses	(276)	(299)	(329)	(362)	(398)
Administrative expenses	(301)	(357)	(428)	(505)	(581)
Other incomes	91	101	110	118	125
Other expenses	(21)	0	0	0	0
Fair value adjustments	(78)	(20)	(10)	(15)	(35)
Operating profit	(161)	(131)	(164)	(214)	(267)
Finance expense	(6)	(5)	(6)	(7)	(7)
Associates & JVs	13	(15)	(10)	(10)	(10)
EBT	(154)	(151)	(180)	(231)	(284)
Taxation	(4)	(1)	(2)	(2)	(2)
Profit After Tax	(158)	(152)	(182)	(233)	(286)
Profit from discontinued operations	59	268	0	0	0
Profit for the year	(99)	116	(182)	(233)	(286)
Minority interest	6	2	10	11	13
Net Profit	(93)	118	(172)	(222)	(273)
EPS	(0.111)	0.138	(0.191)	(0.246)	(0.303)

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 \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 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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