

29 October 2014

KINGSOFT (3888.HK)

Amendment on previous estimates after profit warning

HONG KONG | SOFTWARE | COMPANY UPDATES

- Kingsoft issued profit warning on Oct 23 that the 3Q operating profit was expected to decline significantly yoy.
- The decline was mainly due to significant increase of selling and marketing expenses, R&D cost and share-based compensation.
- We adjusted up the 2015 onwards revenue forecasts, while significantly increased the cost and expenses estimates.
- Since the serious declining in stock price, we upgrade Kingsoft's rating to "Accumulate" with target price HK\$ 19.83, equivalent to 27.2x/37.2x of 2014 and 2015 forecasted EPS.

Financial Highlights

Kingsoft issued profit warning on Oct 23 that the operating profit of the 3Q was expected to decline significantly, compared to the same period last year. This was mainly caused by 1) the sharply increase of selling and marketing expenses for mobile games launching and international mobile internet penetration; 2) the R&D cost rose significantly as the expansion of mobile application team; 3) the rapid rise of share-based compensation costs granted to employees.

How we view this

Mentioned in the last report, the management had already expected the dropping in margins, around 10% to 20%, while restated that the increase in expenses was in line with their business strategies of 2014. However, when it mentioned a much lower 3Q operating profit compared to 2013, it was still out of our estimates and thus we turn to pessimistic in the second half margins of 2014. We maintain the revenue of 2014 and adjusted up the afterwards, due to the company's heavy investment on mobile and internet and the considerable growth in the mobile monthly active users. But we sharply increased the cost and expenses estimates, especially in 2014 and 2015.

Investment Action

However, since the stock price had suffered from serious declining after the 2Q results and a rapid slump at the day of profit warning, we believe it is indeed undervalued. Thus, we upgrade our rating of Kingsoft to "Accumulate" with target price of HK\$ 19.83, equivalent to 27.2x/37.2x of 2014 and 2015 forecasted EPS.

Key Financial Summary

FYE Dec	FY12	FY13	FY14E	FY15E	FY16E
Revenue (RMB mn)	1,411	2,173	3,215	4,500	5,850
Net Profit (RMB mn)	432	670	697	509	743
EPS (HKD)	0.469	0.720	0.729	0.533	0.778
P/E (X)	36.2	23.6	23.3	31.9	21.9
BVPS (HKD)	2.902	4.116	4.740	5.273	6.051
P/B (X)	5.9	4.1	3.6	3.2	2.8
DPS (HKD)	0.11	0.12	0.13	0.14	0.15
Div. Yield (%)	0.6%	0.7%	0.8%	0.8%	0.9%

Source: PSR est.

*All multiples & yields based on current market price

Rating: **Accumulate**

Upgrade to Accumulate

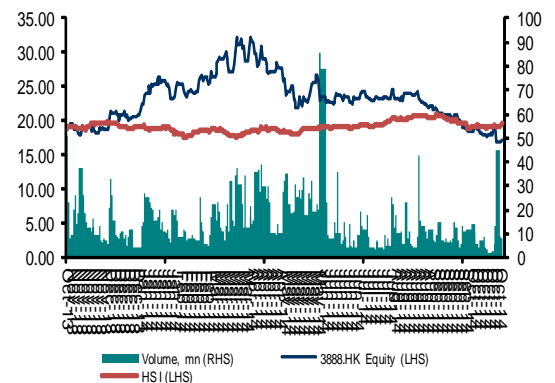
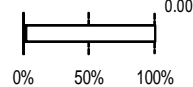
Target Price (HKD)	19.83
Forecast Dividend (HKD)	0.13
Closing Price (HKD)	17.00
Potential Upside	16.6%

Company Description

Kingsoft is a leading Internet-based software companies in China. It provides online games, Internet security software, office software and cloud services. Products are mainly sold in the mainland China, but also exported to Hong Kong, Macao, Taiwan and Southeast Asian countries.

Company Data

Raw Beta (Past 2yrs weekly data)	N/A
Market Cap. (HKD bn)	20,325
Enterprise Value (HKD mn)	16,334
52 week range (HKD)	16.6 - 33.5
Closing Price in 52 week range	0.00



Major Shareholders

1. Lei Jun	14.79%
2. Tencent Holdings	12.60%
3. Kau Pak Kwan	9.13%

Valuation Method

PE

Business event tracking

1. Disposal of Kuaipan Personal with estimated consideration of US\$33 million to Cheetah in September. With this the one-off disposal gain, Kingsoft was able to maintain yoy growth on profit before tax in 3Q2014.
2. Kingsoft's subsidiary Chengdu Westhouse will acquire the stake of a web games developer, Zhuhai Funova with total consideration of approximately RMB50 million. After all, Westhouse will hold 20% stake of Zhuhai Funova.
3. The company had collaborated with Amazon to help in developing office software for its Kindle Fire.
4. News on PRC government's instruction towards state departments on replacing Windows with mainland developed software.

Valuation

The forecasted 2014 profit was sharply cut down by 13.5% to RMB 697 mn. The target price of HK\$ 19.83 was calculated by business value shown as below, plus net cash per share of HK\$ 6.39.

Table 1 Valuation

	2014E profit	HKD	EPS	PE	Valuation
Online games	277.9	345	0.291	10x	2.91
Internet services	333.3	413	0.349	25x	8.72
Software	86.4	107	0.090	20x	1.81
Total	697.6	865	0.730		13.44

*conversion rate 1.24 HKD:RMB

Source: PSR

Potential Risks

Growth on mobile business cannot maintain;
 Rapid rise on cost and expenses.

	FY12	FY13	FY14E	FY15E	FY16E
Valuation Ratios					
P/E (X)	36.2	23.6	23.3	31.9	21.9
P/B (X)	5.9	4.1	3.6	3.2	2.8
EV/EBITDA (X)	39.5	24.0	30.8	26.7	18.9
Dividend Yield (%)	0.6%	0.7%	0.8%	0.8%	0.9%
Per share data (HKD)					
EPS	0.469	0.720	0.729	0.533	0.778
DPS	0.110	0.120	0.130	0.140	0.150
BVPS	2.902	4.116	4.740	5.273	6.051
Outstanding Shares (mn)	1,142.83	1,154.13	1,184.43	1,184.43	1,184.43
Growth & Margins (%)					
Growth					
Revenue	38.3%	54.0%	48.0%	40.0%	30.0%
EBIT	24.8%	64.7%	-22.3%	15.5%	41.0%
Margins					
Gross profit margin	86.8%	86.3%	84.0%	82.0%	79.0%
EBITDA margin	29.3%	31.4%	16.5%	13.6%	14.8%
EBT margin	37.4%	38.0%	27.7%	17.3%	17.9%
Net Profit Margin	30.6%	30.9%	21.7%	11.3%	12.7%
Income Statement (RMB mn)					
Revenue	1,411	2,173	3,215	4,500	5,850
Cost of revenue	(187)	(297)	(514)	(810)	(1,229)
Gross profit	1,224	1,876	2,701	3,690	4,622
Selling & Marketing expenses	(234)	(383)	(836)	(1,215)	(1,463)
Administrative expenses	(148)	(192)	(289)	(405)	(527)
R & D expenses	(385)	(596)	(997)	(1,395)	(1,697)
Other income	29	46	32	35	40
Other expense	(71)	(69)	(81)	(98)	(113)
Operating profit	414	682	530	612	863
Non operating income (expense)	16	37	223	10	10
Net finance income (expense)	98	106	137	156	172
Profit Before Tax	528	825	890	778	1,045
Taxation	(61)	(71)	(94)	(120)	(139)
Profit After Tax	466	754	796	658	906
Minority interest	(34)	(83)	(99)	(149)	(163)
Net Profit	432	670	697	509	743
EPS	0.378	0.581	0.588	0.430	0.627

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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