

Kingsoft (3888.HK)

2019Q3 in-line; Cloud services plans to spin-off and separate listing

6 December 2019

Hong Kong | TMT | Company Report

Investment Summary

Kingsoft's overall performance in 2019Q3 was better than expected. The online game business meets expectations; the increase in corporate cloud revenue drives the rapid growth of cloud services business; the enhanced user engagement and increased paid users promotes the strong growth from value-added services revenue of WPS Office personal edition.

Result update

Kingsoft announced its 2019Q3 results on November 13th: revenue for the third quarter of 2019 increased 32% year-on-year and 8% quarter-on-quarter to RMB2,022.9 million (RMB, the same below). Gross profit increased 18% year-on-year and 15% quarter-on-quarter to RMB822.9 million. Gross profit margin decreased by four percentage points year-on-year and increased by three percentage points quarter-on-quarter to 41%. The year-on-year decrease of the gross profit margin was largely due to our change in sales mix. The quarter-on-quarter increase of gross profit margin mainly reflected improved operating efficiency of cloud business. Profit attributable to owners of the parent was RMB36.1 million for the three months ended 30 September 2019.

Online games: New games launch next year, performance is expected to recover

Revenue from Online games for Q3 was 664 million yuan, a year-on-year decrease of 2%. The year-on-year decrease in revenue was mainly reflected decreased revenue from existing games, partially offset by the revenue contribution from newly released mobile games this year. JX Online III PC game will be updated at the end of the year. A new mobile game Double Life World (雙生視界) was launched in Japan and the domestic version of the game will be released in the near future. In addition, the company also has three new mobile games in stock and is expected to go online in 2020. With the update of old games and the promotion of mobile game diversified product strategies, the game business is expected to recover in 2020.

Cloud services: maintain rapid growth, Q3 gross margin turned positive

Revenue from the cloud services for the third quarter of 2019 increased 62% year-on-year and 6% quarter-on-quarter to RMB976.3 million. The rapid year-on-year increase was mainly driven by an increase of customer usage from mobile video sector and increased revenue from enterprise cloud. Meanwhile, Q3 cloud business gross margin turned positive. At present, cloud services continues to expand its field of game cloud, government cloud, financial cloud and others. It is believed that the cloud business can still maintain rapid growth, and it is not difficult to meet management's 70% growth guidance for the whole year. The company issued an announcement on November 14 that the company is considering a possible spin-off and separate listing of Kingsoft Cloud Holdings Limited, but did not announce any further information.

Office software: Strong growth of member value-added services and has been listed on Sci-Tech board

Revenue from the office software and services and others for the third quarter of 2019 increased 50% year-on-year and decreased 1% quarter-on-quarter to RMB383.1 million. The year-on-year increase was mainly due to strong growth from

Buy

CMP HKD 17.60

(Closing price at 4 December 2019)

TARGET HKD 23.86 (+35.60%)

COMPANY DATA

O/S SHARES (MN) :	1373
MARKET CAP (HKD B) :	24,16
52 - WK HI/LO (HKD):	22.25 / 10.8

SHARE HOLDING PATTERN , %

Mr. Lei Jun	15.30
Mr. Qiu Bojun	7.87

PRICE PERFORMANCE , %

	1M	3M	1Y
Kingsoft	-12.22	3.53	29.41
HSI	-5.39	-1.71	-4.39

RETURN VS. HSI



Source: Aastocks, Phillip Securities (HK) Research

KEY FINANCIALS

RMB mn	FY17	FY18	FY19E	FY20E
Revenue	5,181	5,906	7,822	10,061
Net Profit	3,202	389	-1,443	187
EPS, RMB	2.36	0.27	-1.05	0.14
PER, x	6.4	55.0	N/A	117.3
BVPS, RMB	9.1	9.4	8.1	8.7
P/BV, x	1.7	1.7	2.0	1.8
ROE, %	26.5	3.0	-12.2	1.5

Source: Company reports, Phillip Securities Est.

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value-added services of WPS Office personal edition. WPS' user engagement and the paid users continue to rise. The number of paid users for Q3 increased by 120% year-on-year, and it is expected to record a growth of 40% for the whole year. WPS has also officially released an international version for overseas markets. In addition, Office software further explored the government and enterprise user market, and the domestic licensed software business is expected to record a strong improvement.

Office software was officially listed on the Sci-Tech board on November 18. Kingsoft held 52.71% share of Office software after the listing.

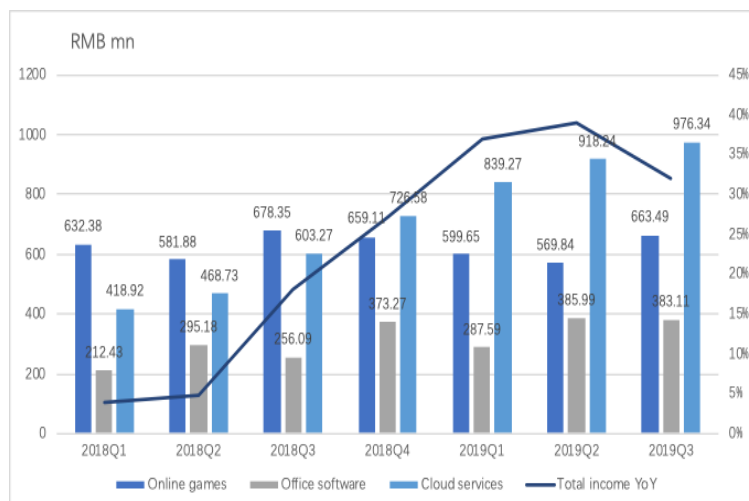
Valuation

We forecast the company's revenue for 2019/2020 to be 7.82 billion yuan / 1.06 billion yuan and adjusted net profit to be -1.44 billion yuan / 1.887 billion yuan. We adopted sum of the parts valuation by dividing the business into three parts: 1) Online games (P/E), 2) Cloud business (P/S), and 3) Office software (P/E). Due to the weak performance of the online game business, it is given a P / E ratio of 10x; the prospect of WPS is optimistic, given a P / E ratio of 35 times; and the cloud business is given a 5 times price-to-sales ratio. The SOTP target price is HKD 23.86, 35.6% higher than the current price. We remain “Buy” rating. (Current price as of December 4, 2019)

Risk

1. Tighter regulation
2. Respond of new mobile games less than expected
3. Fierce competition in cloud business

Figure-1: Kingsoft 2018Q1-2019Q3 segment revenue



Source: Company Report, Phillip Securities (HK) Research

Figure-2: Kingsoft's SOTP valuation table

Segment	Revenue (RMB mn)	Net profit (RMB mn)	Valuation	Multiple	Ownership	Value (RMB mn)	Value (HKD mn)
Online games	2,410	627	P/E	10	67.7%	4,245	4,717
Office software	2,108	506	P/E	35	52.7%	9,333	10,370
Cloud services	5,543	-2,018	P/S	5	51.6%	14,301	15,890
CMCM			Market cap		47.9%	1,606	1,784
Total market cap						29,485	32,761
						Per share value	HKD 23.86

Source: Company Report, Phillip Securities (HK) Research Estimates
Exchange rate: HKD/CNY 0.9

Financials

FYE DEC	FY17	FY18	FY19F	FY20F	FY21F
Valuation Ratios					
P/E (X), adj	6.4	55.0	N/A	117.3	42.9
P/B (X)	1.7	1.7	2.0	1.8	1.7
Dividend Yield (%)	0.60%	N/A	N/A	N/A	0.50%
Per share data (RMB)					
EPS, (Basic)	2.46	0.29	-1.05	0.14	0.37
EPS, (Diluted)	2.36	0.27	-1.05	0.14	0.37
DPS (HKD)	0.11	N/A	N/A	N/A	0.1
BVPS	9.1	9.4	8.1	8.7	9.2
Growth & Margins (%)					
Growth					
Revenue	-37.0%	14.0%	32.4%	28.6%	28.5%
Operating profit (excluding fair value gains on investment properties)	-16.0%	-9.10%	N/A	N/A	N/A
Net Income (excluding gain/loss from discontinued operations)	-1283.0%	-88.0%	-471.0%	N/A	171.6%
Margins					
Gross margin	58.1%	46.3%	39.6%	39.4%	39.2%
Operating profit margin(excluding fair value gains on investment properties)	15.7%	-5.1%	-6.1%	-0.5%	4.2%
Net Profit Margin	61.8%	6.6%	-18.4%	1.9%	3.9%
Key Ratios					
ROE	26.5%	3.0%	-12.2%	1.5%	3.9%
Income statement (RMB mn)					
Revenue	5,181	5,906	7,822	10,061	12,932
Gross Profit	3,012	2,737	3,098	3,962	5,072
EBIT	814	-302	-481	-53	546
EBT	912	-25	-1,854	-229	441
Net profit (excluding gain/loss from discontinued operations)	3,297	-165	-1,964	-348	313
Minority Interest	95	-554	-580	-535	-203
Net profit for owners	3,202	389	-1,443	187	506

Source: Company, Phillip Securities (HK) Research
Exchange rate HKD/RMB 0.9
(Financial figures as at 4 December 2019)

BS						IS					
(RMB mn)	2017A	2018A	2019E	2020F	2021F	(RMB mn)	2017A	2018A	2019E	2020F	2021F
Cash and bank deposits	8,506	9,869	9,175	9,320	9,260	Revenue	5,181	5,906	7,822	10,061	12,932
Inventories	10	12	13	13	15	Online games	3,120	2,552	2,472	2,410	2,358
Trade receivables	1,168	1,185	2,027	2,283	2,606	Cloud services	1,332	2,217	3,771	5,543	7,760
Prepayments	680	906	1,231	1,513	1,736	Office software	729	1,137	1,579	2,108	2,834
Other current assets	181	108	16	62	87	Cost of revenue	-2,169	-3,169	-4,724	-6,082	-7,860
Total current assets	10,545	12,080	12,462	13,191	13,704	Gross profit	3,012	2,737	3,098	3,962	5,072
PPE	1,329	2,036	2,606	3,287	3,817	R&D costs	-1,446	-1,839	-2,082	-2,331	-2,597
Intangible assets	66	66	46	49	56	Selling expense	-545	-727	-966	-1,090	-1,253
Investment in long-term Equity	5,325	5,251	3,942	4,384	4,937	Administrative expense	-257	-449	-487	-536	-594
Other non-current assets	497	617	652	689	730	Share-base compensation	-235	-212	-238	-268	-302
Total non-current assets	7,217	7,970	7,246	8,409	9,540	Other income	285	188	194	210	220
Total assets	17,762	20,050	19,708	21,600	23,244	Operation profit	814	-302	-481	-53	546
Short-term borrowings	374	1,053	731	619	542	Finance costs	83	-1	-94	-87	-79
Trade payables	1,792	2,048	2,776	3,135	3,463	Profit of investment	16	278	-1,279	-89	-26
Other current liabilities	1,688	1,005	1,249	1,461	1,685	Profit before tax	912	-25	-1,854	-229	441
Total current liabilities	3,854	4,106	4,756	5,215	5,690	Income tax expense	-134	-140	-110	-119	-128
Long-term borrowings	288	231	186	212	237	Net profit	3,297	-165	-1,964	-348	313
Convertible preferred share:	950	2,742	3,481	3,983	4,351	Non-controlling profit	95	-554	-580	-535	-203
Other non-current liabilities	117	49	224	254	278	Owners of the parent	3,202	389	-1,443	187	506
Total non-current Liabilities	1,355	3,022	3,891	4,449	4,866	EPS	2.36	0.27	-1.05	0.14	0.37
Total liabilities	5,209	7,128	8,647	9,664	10,556						
Non-controlling interests	464	-116	-756	-438	-205						
Equity attributable to Owners of the parents	12,089	13,038	11,817	12,374	12,893						
Total equity	12,553	12,922	11,061	11,936	12,688						
CF						Key Ratios					
(RMB mn)	2017A	2018A	2019E	2020F	2021F	(RMB mn)	2017A	2018A	2019E	2020F	2021F
Cash flows from Operating activities	1,890	770	462	834	1,309	Growing ability					
Net profit	3,202	389	-1,443	187	506	Revenue	-37%	14%	32%	29%	29%
Depreciation	359	480	625	802	1,010	Gross profit	-46%	-9%	13%	28%	28%
Change of working capital	154	426	-268	276	391	Operating profit	-16%	-9%	—	—	—
Others	-532	288	1,548	-431	-598	Net profit	-1283%	-88%	-471%	N/A	171%
Cash flows from Investing activities	-4,108	-780	-1,756	-1,595	-1,791	Profitability					
Capital expenditure	-692	-1,420	-1,360	-1,247	-1,385	Gross profit margin	58.1%	46.3%	39.6%	39.4%	39.2%
Others	-3,416	640	-396	-348	-406	Operating profit margin	15.7%	-5.1%	-6.1%	-0.5%	4.2%
Cash flows from Financing activities	-266	1,510	-438	218	389	Net profit margin	61.8%	6.6%	-18.4%	1.9%	3.9%
Borrowings	-352	1,871	-367	-86	16	Solvency					
Equity financing	432	15	0	0	0	Current ratio	2.7	2.9	2.6	2.5	2.4
Others	-346	-376	-71	304	373	Quick ratio	2.7	2.9	2.6	2.5	2.4
Net increase in cash and Cash equivalents	-2,484	1,500	-1,732	-543	-93	Debt-Asset ratio	29.3%	35.6%	43.9%	44.7%	45.4%
						Rate of return					
						ROE	26.5%	3.0%	-12.2%	1.5%	3.9%
						ROA	18.0%	1.9%	-7.3%	0.9%	2.2%
						Per share ratio					
						Net profit per share	2.33	0.28	-1.05	0.14	0.37
						Dividends per share (HKD)	0.11	—	—	—	0.1
						Book value per share	9.11	9.43	8.14	8.74	9.22
						Valuation					
						P/E	6.4	55.0	—	117.3	42.9
						P/B	1.7	1.7	2.0	1.8	1.7

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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