

# Chinasoft (354 HK)

## Huawei worsening balance sheet adds uncertainty

Huawei expects FY21 revenue to decline at 29% YoY to RMB634bn, first YoY decline in the past decade. We believe Huawei will continue to spend big in R&D as the Company continues to shift its business from hardware to software/ cloud-centric. However, we are concerned that Huawei will squeeze suppliers' margin as outlook dims. We cut Chinasoft FY21-23E net profit by 7-12% on lower GPM and higher labor cost pressure. Maintain BUY with lower target price of HK\$11.26 (prior HK\$17.53) given rising uncertainty related to Huawei's business profitability.

- Huawei FY21 revenue to decline at 29% YoY.** On 31 Dec 2021, Huawei wrote in a new year letter that the Company expects FY21 revenue to come in at RMB634bn (-28.9% YoY) and FY22 will remain challenging. This is the first YoY decline in revenue for Huawei in the past decade, as a result from U.S. sanctions affecting its consumer business (Honor divestment).
- Huawei may squeeze suppliers' margin as outlook dims.** We believe Huawei will continue to spend big in R&D amid the business transition from hardware to software/ cloud-centric. Although Huawei has ample cash on hand (RMB357bn as of 31 Dec 2020), we are concerned that Huawei will ask for price cut and squeeze suppliers' margin as business environment gets more difficult in 2022.
- Chinasoft FY21 net profit growth target could miss.** Huawei accounted for 55% of Chinasoft FY20 revenue (IT outsourcing + Cloud). Although demand from Huawei is strong, as reflected in increasing Chinasoft employee number (+22% YoY to 83,138 in FY1H21), we are concerned that Huawei's worsening balance sheet could affect Chinasoft GPM and that its FY21 +30% YoY net profit target could miss. We now expect Chinasoft FY21 net profit growth of +20% YoY to RMB1,143mn. We estimate FY2H21 GPM of 30.5%, lower than the level before COVID-19 (31.0% in FY2H19).
- Maintain BUY but cut target price to HK\$11.26.** We cut FY21-23E net profit by 7-12% to reflect lower GPM and higher labor cost pressure. Maintain BUY but revised down target price to HK\$11.26 (prior HK\$17.53), based on lowered 23x FY22E fully diluted EPS given increasing uncertainty related to Huawei's business profitability.

### Earnings Summary

(YE 31 Dec)	FY19A	FY20A	FY21E	FY22E	FY23E
Revenue (RMB mn)	12,042	14,101	18,166	22,352	26,825
YoY growth (%)	10%	15%	28%	23%	20%
Net profit (RMB mn)	755	955	1,143	1,356	1,696
EPS (RMB)	0.28	0.32	0.36	0.43	0.54
YoY growth (%)	10%	13%	14%	19%	25%
Consensus EPS (RMB)	0.28	0.32	0.44	0.58	0.74
PE (x)	27.1	24.1	21.2	17.9	14.3
EV/Sales (x)	1.8	1.4	1.1	0.8	0.6
Dividend Yield (%)	0.00	0.00	0.00	0.00	0.00
ROE (%)	12%	12%	12%	13%	14%
Net debt to equity	net cash	net cash	net cash	net cash	net cash

Source: Company data, Bloomberg, CMBIS estimates

### BUY (Maintain)

Target Price	HK\$11.26
(Previous TP)	HK\$17.53)
Up/Downside	+28.8%
Current Price	HK\$8.74

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#### Stock Data

Mkt Cap (HK\$ mn)	26,822
Avg 3 mths t/o (HK\$ mn)	196.88
52w High/Low (HK\$)	16.28/ 6.83
Total Issued Shares (mn)	3,069

Source: Bloomberg

#### Shareholding Structure

Chen Yuhong- Chairman	13.1%
UBS Group AG	10.3%
Share Award Scheme	6.0%

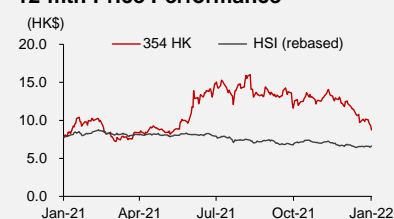
Source: HKEx

#### Share Performance

	Absolute	Relative
1-mth	-20.8%	-19.9%
3-mth	-19.5%	-16.4%
6-mth	-36.9%	-23.2%

Source: Bloomberg

#### 12-mth Price Performance



Source: Bloomberg

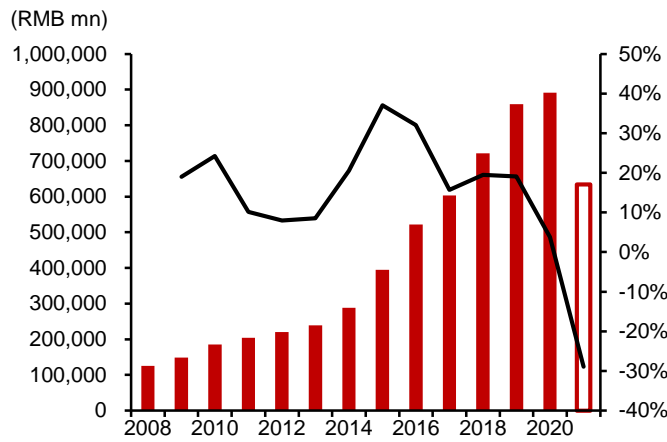
#### Auditor: Deloitte

#### Related Reports

- China Software & IT Services – "China cloud outlook mixed" – 4 Nov 2021
- Chinasoft (354 HK) – "Strong demand but labour cost weigh on margins" – 25 Aug 2021

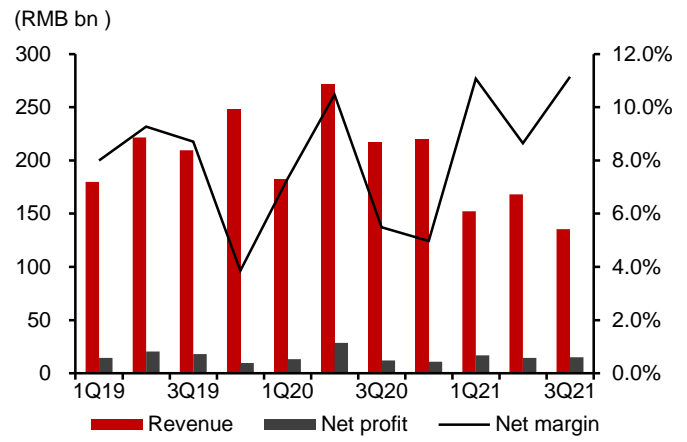
**Focus Charts**

**Figure 1: Huawei FY21 revenue is expected to decline at 28.9% YoY**



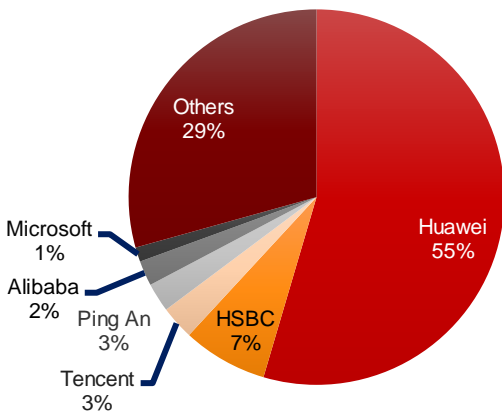
Source: Company data, CMBIS estimates

**Figure 2: Huawei net profit dropped significantly since 1Q21**



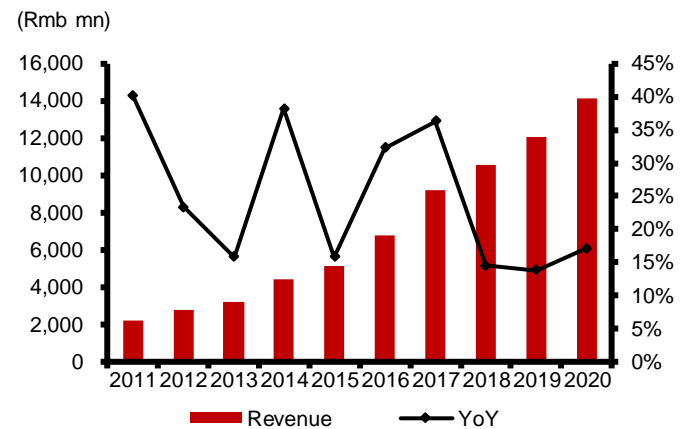
Source: Company data, CMBIS estimates

**Figure 3: Customer breakdown (2020)**



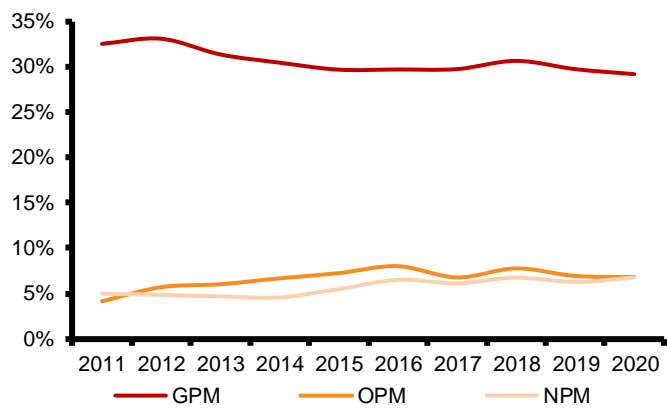
Source: Company data, CMBIS estimates

**Figure 4: Chinasoft revenue and growth**



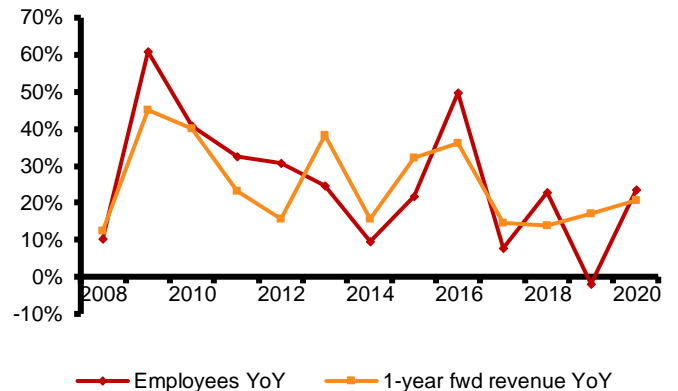
Source: Company data, CMBIS estimates

**Figure 5: Margins**



Source: Company data, CMBIS estimates

**Figure 6: Forward revenue and employees**



Source: Company data, CMBIS estimates

## Earnings revision

Figure 7: Earnings revision

RMB mn	2021E			2022E			2023E		
	New	Old	%Diff	New	Old	%Diff	New	Old	%Diff
Sales	18,166	18,166	-	22,352	22,352	-	26,825	26,825	-
Gross profit	5,290	5,339	-1%	6,483	6,643	-2%	7,768	7,976	-3%
OP Profit	1,003	1,076	-7%	1,308	1,499	-13%	1,618	1,738	-7%
PBT	1,229	1,303	-6%	1,447	1,638	-12%	1,823	1,943	-6%
Net profit	1,143	1,214	-6%	1,356	1,536	-12%	1,696	1,810	-6%
EPS (RMB)	0.37	0.41	-9%	0.43	0.51	-16%	0.54	0.60	-11%
<b>Margins</b>									
GM	29.1%	29.4%	-27 bps	29.0%	29.7%	-72 bps	29.0%	29.7%	-78 bps
OPM	5.5%	5.9%	-41 bps	5.9%	6.7%	-85 bps	6.0%	6.5%	-45 bps
PBT margin	6.8%	7.2%	-41 bps	6.5%	7.3%	-85 bps	6.8%	7.2%	-45 bps
Net margin	6.3%	6.7%	-39 bps	6.1%	6.9%	-80 bps	6.3%	6.7%	-43 bps

Source: Company data, CMBIS estimates

Figure 8: CMBIS estimates vs consensus

RMB mn	2021E			2022E			2023E		
	CMBIS	Street	Diff	CMBIS	Street	Diff	CMBIS	Street	Diff
Sales	18,166	18,076	0%	22,352	22,408	-0%	26,825	27,347	-2%
Gross profit	5,290	5,364	-1%	6,483	6,739	-4%	7,768	8,307	-6%
OP Profit	1,003	1,369	-27%	1,308	1,796	-27%	1,618	2,227	-27%
PBT	1,229	1,376	-11%	1,447	1,847	-22%	1,823	2,370	-23%
Net profit	1,143	1,263	-9%	1,356	1,696	-20%	1,696	2,180	-22%
EPS (RMB)	0.37	0.44	-14%	0.43	0.57	-24%	0.54	0.71	-24%
<b>Margins</b>									
GM	29.1%	29.7%	-55 bps	29.0%	30.1%	-107 bps	29.0%	30.4%	-142 bps
OPM	5.5%	7.6%	-206 bps	5.9%	8.0%	-216 bps	6.0%	8.1%	-211 bps
PBT margin	6.8%	7.6%	-84 bps	6.5%	8.2%	-177 bps	6.8%	8.7%	-187 bps
Net margin	6.3%	7.0%	-69 bps	6.1%	7.6%	-150 bps	6.3%	8.0%	-165 bps

Source: Company data, CMBIS estimates

## Operating model

Figure 9: Operating model

RMB mn	2019	2020	2021E	2022E	2023E
Revenues	12,042	14,101	18,166	22,352	26,825
Cost of sales	(8,459)	(9,983)	(12,875)	(15,869)	(19,057)
Gross Profit	3,583	4,118	5,290	6,483	7,768
<i>Gross margin</i>	<i>29.8%</i>	<i>29.2%</i>	<i>29.1%</i>	<i>29.0%</i>	<i>29.0%</i>
R&D	(809)	(930)	(1,326)	(1,661)	(2,006)
SG&A	(1,813)	(2,031)	(2,899)	(3,467)	(4,099)
Operating Income	827	952	1,003	1,308	1,618
<i>Operating margin</i>	<i>6.9%</i>	<i>6.7%</i>	<i>5.5%</i>	<i>5.9%</i>	<i>6.0%</i>
Non-Operating Income	(28)	83	227	139	205
Profit Before Tax	799	1,035	1,229	1,447	1,823
Income tax (expense) gain	(42)	(87)	(87)	(96)	(131)
Minorities	2	(7)	(1)	(4)	(4)
Net Income to Shareholders	755	955	1,143	1,356	1,696
<i>Net margin</i>	<i>6.3%</i>	<i>6.8%</i>	<i>6.3%</i>	<i>6.1%</i>	<i>6.3%</i>
EPS (RMB)	0.31	0.33	0.37	0.43	0.54
Fully diluted EPS (RMB)	0.28	0.32	0.36	0.43	0.54
<b>Revenue breakdown</b>					
IT outsourcing	10,042	10,830	12,833	14,887	17,120
Emerging cloud business	2,000	3,271	5,333	7,466	9,705
Huawei	6,570	8,030	9,664	11,113	12,558
HSBC	880	830	872	872	872
Tencent	350	500	725	979	1,175
Alibaba	260	400	620	868	1,128
Ping An	300	450	698	977	1,172
Others	3,682	3,891	5,588	7,544	9,921
<b>Growth YoY</b>					
Revenues	14%	17%	29%	23%	20%
Gross profit	10%	15%	28%	23%	20%
Operating Income	1%	15%	5%	31%	24%
EPS	4%	7%	13%	15%	25%

Source: Company data, CMBIS estimates

**Figure 10: Semi-annual operating model**

RMB mn	1H19	2H19	1H20	2H20	1H21	2H21E
Revenues	5,538	6,504	6,059	8,042	8,341	9,825
Gross Profit	1,567	2,016	1,649	2,469	2,294	2,997
Operating profit	426	401	421	531	423	580
Net profit (loss)	363	392	401	554	518	625
EPS (RMB)	0.15	0.16	0.16	0.19	0.19	0.20
<b>Margins</b>						
Gross margin	28.3%	31.0%	27.2%	30.7%	27.5%	30.5%
Operating margin	7.7%	6.2%	6.9%	6.6%	5.1%	5.9%
Net margin	6.5%	6.0%	6.6%	6.9%	6.2%	6.4%
<b>Growth (HoH)</b>						
Revenues	-4%	17%	-7%	33%	4%	18%
Gross Profit	-16%	29%	-18%	50%	-7%	31%
Operating profit	14%	-6%	5%	26%	-20%	37%
Net profit (loss)	2%	8%	2%	38%	-6%	21%
<b>Growth (YoY)</b>						
Revenues	15%	13%	9%	24%	38%	22%
Gross Profit	13%	9%	5%	22%	39%	21%
Operating profit	-3%	7%	-1%	32%	0%	9%
Net profit (loss)	1%	10%	11%	41%	29%	13%

Source: Company data, CMBIS estimates

## Valuation

### Chinasoft (354 HK, BUY, TP HK\$11.26)

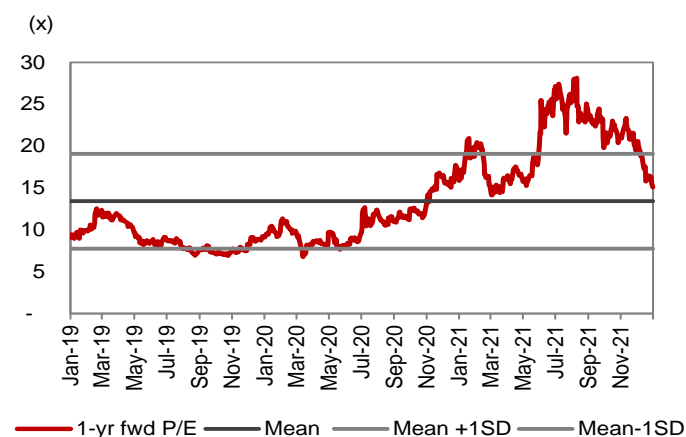
We have BUY rating on Chinasoft with target price of HK\$11.26, based on lowered 23x (prior 30x) FY22E fully diluted EPS, in-line with peers average. We use a lower target multiple given increasing uncertainty to Huawei business margin.

**Figure 11: Peers' valuation**

Company	Ticker	Rating	Mk Cap (US\$ mn)	Price (LC)	TP (LC)	P/E		ROE		Sales CAGR	EPS CAGR	
						FY21E	FY22E	FY21E	FY22E	FY20-22	FY20-22	
Chinasoft	354 HK	BUY	3,439	8.74	11.26	21.2	17.9	12.2	12.9	24%	19%	
Digital China	000034 CH	NR	1,689	16.30	N/A	13.6	10.5	14.8	16.3	9%	25%	
Infosys	INFO IN	NR	102,760	1817.05	N/A	39.6	34.4	28.4	29.2	14%	16%	
Tata Consultancy	TCS IN	NR	190,722	3831.05	N/A	43.4	36.6	38.0	41.1	11%	11%	
						<b>Mean</b>	<b>29.4</b>	<b>24.8</b>	<b>23.3</b>	<b>24.9</b>	<b>15%</b>	<b>18%</b>
						<b>Median</b>	<b>39.6</b>	<b>34.4</b>	<b>28.4</b>	<b>29.2</b>	<b>11%</b>	<b>16%</b>

Source: Bloomberg, CMBIS

**Figure 12: 12M forward P/E chart**



Source: Company data, CMBIS

**Figure 13: 12M forward P/E band**



Source: Company data, CMBIS

## Financial Summary

Income statement						Cash flow summary					
YE 31 Dec (RMB mn)	FY19A	FY20A	FY21E	FY22E	FY23E	YE 31 Dec (RMB mn)	FY19A	FY20A	FY21E	FY22E	FY23E
<b>Revenue</b>	<b>12,042</b>	<b>14,101</b>	<b>18,166</b>	<b>22,352</b>	<b>26,825</b>	<b>Net profit</b>	<b>799</b>	<b>1,035</b>	<b>1,229</b>	<b>1,447</b>	<b>1,823</b>
Cost of sales	(8,459)	(9,983)	(12,875)	(15,869)	(19,057)	Depreciation/amortization	197	170	109	111	115
<b>Gross profit</b>	<b>3,583</b>	<b>4,118</b>	<b>5,290</b>	<b>6,483</b>	<b>7,768</b>	Change in working capital	(516)	(533)	(185)	46	(681)
Selling exp	(618)	(729)	(923)	(1,073)	(1,288)	Others	274	480	173	(96)	(131)
Admin exp	(1,196)	(1,302)	(1,976)	(2,394)	(2,811)	<b>Net cash from operating</b>	<b>754</b>	<b>1,153</b>	<b>1,327</b>	<b>1,509</b>	<b>1,126</b>
R&D exp	(809)	(930)	(1,326)	(1,661)	(2,006)	Capex	(105)	(159)	(150)	(150)	(150)
Other operating exp.	(134)	(205)	(63)	(48)	(46)	Others	(120)	(32)	(221)	(48)	(46)
<b>Operating profit</b>	<b>827</b>	<b>952</b>	<b>1,003</b>	<b>1,308</b>	<b>1,618</b>	<b>Net cash from investing</b>	<b>(224)</b>	<b>(192)</b>	<b>(371)</b>	<b>(198)</b>	<b>(196)</b>
Finance costs	(166)	(151)	(111)	(130)	(135)	Net borrowings	52	217	1,176	(3)	307
Other non-oper exp.	138	235	338	269	340	Dividend paid	-	-	(69)	(81)	(102)
<b>Pre-tax profit</b>	<b>799</b>	<b>1,035</b>	<b>1,229</b>	<b>1,447</b>	<b>1,823</b>	Others	(701)	145	(188)	4	4
Income tax expense	(42)	(87)	(87)	(96)	(131)	<b>Net cash from financing</b>	<b>(650)</b>	<b>362</b>	<b>919</b>	<b>(80)</b>	<b>209</b>
Minority interests	2	(7)	(1)	(4)	(4)	<b>Net change in cash</b>	<b>(119)</b>	<b>1,323</b>	<b>1,875</b>	<b>1,232</b>	<b>1,140</b>
<b>Net profit to shareholders</b>	<b>755</b>	<b>955</b>	<b>1,143</b>	<b>1,356</b>	<b>1,696</b>	Cash at beginning of the year	2,646	2,526	3,787	5,758	7,038
						Exchange difference	(1)	(62)	96	48	46
						<b>Cash at the end of the year</b>	<b>2,526</b>	<b>3,787</b>	<b>5,758</b>	<b>7,038</b>	<b>8,223</b>

Balance sheet						Key ratios					
YE 31 Dec (RMB mn)	FY19A	FY20A	FY21E	FY22E	FY23E	YE 31 Dec	FY19A	FY20A	FY21E	FY22E	FY23E
<b>Current assets</b>	<b>8,198</b>	<b>10,394</b>	<b>12,865</b>	<b>14,779</b>	<b>17,345</b>	<b>Revenue mix</b>					
Cash & equivalents	2,526	3,787	5,758	7,038	8,223	Emerging cloud business	15%	17%	23%	29%	33%
Account receivables	3,297	4,580	4,317	4,255	4,920	Traditional IT outsourcing	85%	83%	77%	71%	67%
Amount due from customers	2,228	1,904	2,619	3,287	3,973	<b>Growth (%)</b>					
Other current assets	147	123	171	200	229	Revenue	14%	17%	29%	23%	20%
<b>Non-current assets</b>	<b>2,547</b>	<b>2,693</b>	<b>2,979</b>	<b>3,018</b>	<b>3,053</b>	Gross profit	10%	15%	28%	23%	20%
PPE	802	858	924	1,010	1,091	Operating profit	1%	15%	5%	31%	24%
Intangible assets	1,101	1,086	1,126	1,079	1,033	Net profit	5%	26%	20%	19%	25%
Other non-current assets	643	749	929	929	929	<b>Profit &amp; loss ratio (%)</b>					
<b>Total assets</b>	<b>10,745</b>	<b>13,087</b>	<b>15,844</b>	<b>17,797</b>	<b>20,398</b>	Gross margin	29.8%	29.2%	29.1%	29.0%	29.0%
<b>Current liabilities</b>	<b>3,150</b>	<b>2,718</b>	<b>4,746</b>	<b>5,425</b>	<b>6,340</b>	Operating margin	6.9%	6.7%	5.5%	5.9%	6.0%
ST borrowings	1,523	368	2,073	2,071	2,286	Net profit margin	6.3%	6.8%	6.3%	6.1%	6.3%
Account payables	1,229	1,753	2,619	3,287	3,973	<b>Balance sheet ratio</b>					
Accrued expense	106	117	0	0	0	Receivable turnover days	99	117	86	69	66
Other current liabilities	291	480	54	67	81	Amount due days	67	49	52	53	53
<b>Non-current liabilities</b>	<b>1,062</b>	<b>1,592</b>	<b>1,185</b>	<b>1,184</b>	<b>1,276</b>	Payable turnover days	52	63	73	75	75
LT borrowings	928	1,421	892	891	983	Current ratio (x)	2.60	3.82	2.71	2.72	2.74
Other non-current liabilities	134	171	293	293	293	Net debt to equity	net cash	net cash	net cash	net cash	net cash
<b>Total liabilities</b>	<b>4,211</b>	<b>4,311</b>	<b>5,931</b>	<b>6,609</b>	<b>7,616</b>	<b>Profitability (%)</b>					
Share capital	116	132	132	132	132	ROE	12.0%	12.5%	12.2%	12.9%	14.1%
Capital surplus	3,145	4,735	4,674	4,674	4,674	ROIC	12.9%	13.5%	13.8%	17.7%	20.7%
Retained earnings	3,677	4,492	5,615	6,890	8,484	<b>Per share data (RMB)</b>					
Other reserves	-471	-605	-530	-530	-530	EPS (RMB)	0.28	0.32	0.36	0.43	0.54
Minority interest	66	23	22	22	22	DPS (RMB)	0.02	0.03	0.02	0.03	0.03
<b>Total equity</b>	<b>6,534</b>	<b>8,776</b>	<b>9,913</b>	<b>11,188</b>	<b>12,782</b>	BVPS (RMB)	2.45	2.93	3.14	3.54	4.05
<b>Total liabilities and equity</b>	<b>10,745</b>	<b>13,087</b>	<b>15,844</b>	<b>17,797</b>	<b>20,398</b>						

# Disclosures & Disclaimers

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## CMBIS Ratings

**BUY** : Stock with potential return of over 15% over next 12 months  
**HOLD** : Stock with potential return of +15% to -10% over next 12 months  
**SELL** : Stock with potential loss of over 10% over next 12 months  
**NOT RATED** : Stock is not rated by CMBIS

**OUTPERFORM** : Industry expected to outperform the relevant broad market benchmark over next 12 months  
**MARKET-PERFORM** : Industry expected to perform in-line with the relevant broad market benchmark over next 12 months  
**UNDERPERFORM** : Industry expected to underperform the relevant broad market benchmark over next 12 months

## CMB International Securities Limited

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