

Chinasoft (354 HK)

Business outlook read-through from iSoftStone

Chinasoft's biggest competitor iSoftStone has filed A-share IPO recently. iSoftStone delivered +28% YoY revenue growth in FY21 to RMB16.6bn but GPM dropped 2.5 pts to 24.7% given higher staff cost in order to match with Huawei's evolving business needs. With similar business model and customer structure (>55% of revenue from Huawei), we are concerned that Chinasoft will also bear extra costs and thus affect margin. Although long term growth outlook is intact, margin/ macro uncertainty could add pressure to near term share price.

■ Strong revenue growth in FY21 as Huawei expands into new businesses.

iSoftStone, biggest competitor to Chinasoft, filed IPO on ChiNext. The two companies have similar business model, revenue size and customer structure (>55% of revenue from Huawei). iSoftStone FY21 revenue grew at +28% YoY to RMB16.6bn. We attribute the strong results to 1) low base in FY20 due to IT projects delay amid COVID-19 and 2) Huawei is undergoing business transformation with increased investment in software. We expect Chinasoft to deliver similar revenue growth of +29% YoY in FY21 to RMB18.2bn.

■ iSoftStone FY21 margin erosion is largely due to Huawei.

iSoftStone FY21 GPM declined 2.5 pts to 24.7% due to 1) more qualified IT staff hired as Huawei expands into cloud/ HarmonyOS/ autonomous driving and 2) special incentive scheme (RMB196mn) offered to employees working on Huawei projects in FY4Q21. We are concerned that Chinasoft will also incur these extra cost and hence face similar margin decline situation in FY21. We expect Chinasoft FY21 GPM to be at 29.1% (vs. consensus of 29.3%).

■ IT service demand is solid but margin decline may continue.

iSoftStone expects FY1Q22 revenue to grow at +28% YoY to RMB4.6bn while adj. net profit will only grow at +15% YoY to RMB80mn. We are concerned that extra cost spent on Huawei business is not one-off and will continue to affect Huawei IT services partners' gross margin in FY22E.

■ Share price not bottomed yet.

Chinasoft share price dropped 39% YTD and is trading at 12.7x diluted FY22E P/E (below 3-year mean). Although tech companies increasing IT outsourcing spending is a secular trend, we believe share price will be under pressure in the near term given 1) potential margin decline and 2) spreading of Omicron in China could affect delivery schedule of labor-intensive IT services work.

Earnings Summary

(YE 31 Dec)	FY19	FY20	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	0.42	0.54	0.70
PE (x)	19.3	17.1	15.1	12.7	10.2
EV/Sales (x)	1.3	1.0	0.7	0.5	0.4
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, CMBIGM estimates

BUY (Maintain)

Target Price HK\$11.26
(Previous TP) HK\$11.26
Up/Downside +80.7%
Current Price HK\$6.23

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Stock Data

Mkt Cap (HK\$ mn)	19,275
Avg 3 mths t/o (HK\$ mn)	167.84
52w High/Low (HK\$)	16.28/5.94
Total Issued Shares (mn)	3,094

Source: Bloomberg

Shareholding Structure

Chen Yuhong - Chairman	12.4%
UBS Group AG	10.2%
ESOP	6.0%

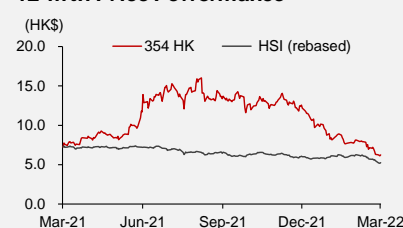
Source: HKEX

Share Performance

	Absolute	Relative
1-mth	-24.6%	-9.2%
3-mth	-51.2%	-42.6%
6-mth	-54.2%	-42.9%

Source: Bloomberg

12-mth Price Performance



Source: Bloomberg

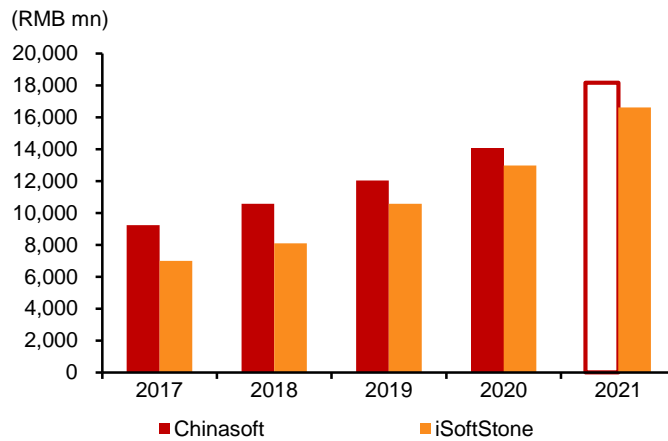
Auditor: Deloitte

Related Reports

1. Chinasoft (354 HK) – “Huawei worsening balance sheet adds uncertainty” – 10 Jan 2022 ([link](#))
2. Chinasoft (354 HK) – “Strong demand but labour cost weighs on margins” – 25 Aug 2021 ([link](#))

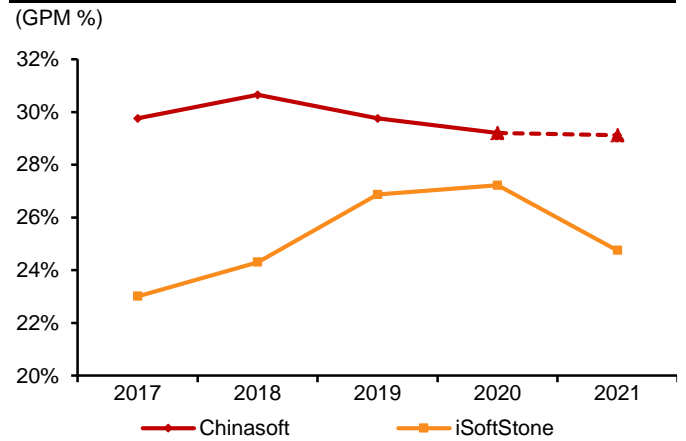
Focus Charts

Figure 1: Chinasoft vs. iSoftStone revenue



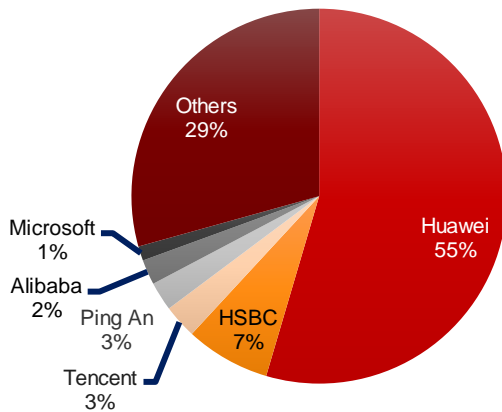
Source: Company data, CMBIGM estimates for Chinasoft 2021E

Figure 2: Chinasoft vs. iSoftStone GPM



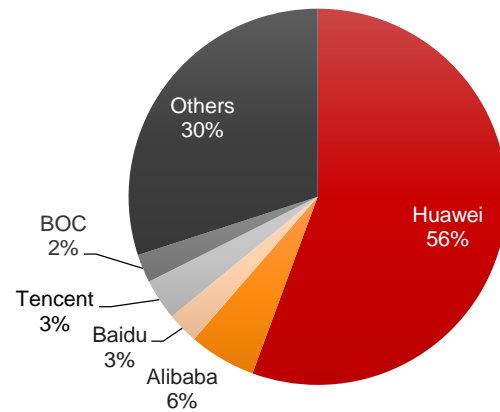
Source: Company data, CMBIGM estimates for Chinasoft 2021E

Figure 3: Chinasoft customer breakdown (2020)



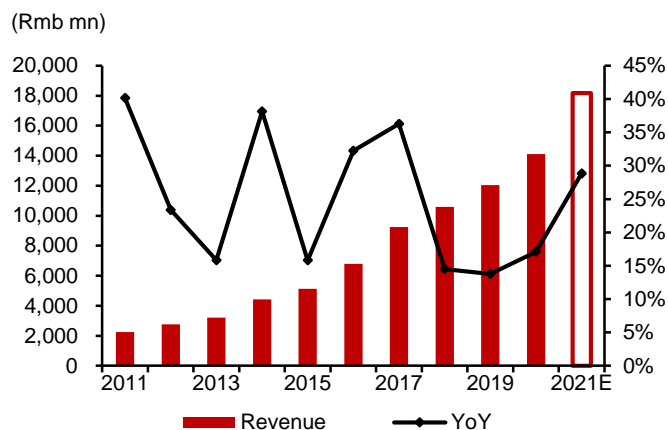
Source: Company data, CMBIGM estimates

Figure 4: iSoftStone customer breakdown (2020)



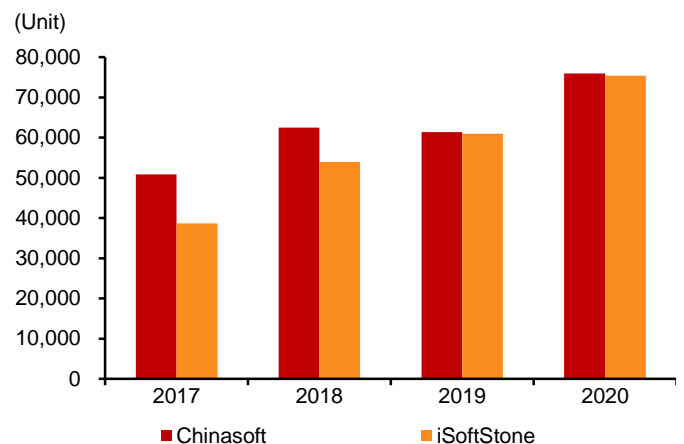
Source: Company data, CMBIGM estimates

Figure 5: Chinasoft revenue and growth



Source: Company data, CMBIGM estimates

Figure 6: Chinasoft vs. iSoftStone employees



Source: Company data, CMBIGM estimates

Readthrough from iSoftStone

iSoftStone filed IPO on ChiNext. iSoftStone is the biggest competitor to Chinasoft. Both are leading third party IT service provider in China. They have similar revenue/ employee size, customer structure (Huawei accounts for approx. 55% of revenue) as well as margins. From iSoftStone financials, we believe there are three read-throughs that could shed some lights on Chinasoft business outlook.

1) iSoftStone delivered strong FY21 revenue growth as Huawei expands into new businesses

iSoftStone FY21 revenue grew at +28% YoY to RMB16,619mn. We attribute the strong result to (i) low base in FY20 due to COVID-19 (labor-intensive IT projects delayed in FY1H20) and (ii) Huawei undergoes software-centric transformation and increased investment in cloud/ Harmony OS. Given a similar revenue structure with >55% of revenue from Huawei, we expect Chinasoft to deliver a similar revenue growth in FY21 at +29% YoY to RMB18,166mn.

2) Gross margin squeezed in FY21, largely related to Huawei

iSoftStone FY21 gross margin declined 2.5 ppts to 24.7%. Company attributed the decline to extra cost resulted from Huawei business transformation.

- (i) To match with Huawei R&D needs in new businesses such as cloud service/ harmony OS/ Kunpeng ecosystem/ autonomous driving, iSoftStone has **hired more qualified IT staff**. This resulted in extra staff cost of RMB119mn in FY21.
- (ii) To increase customer stickiness, starting from FY4Q21, iSoftStone offered **special incentive scheme to employees working on Huawei projects**. According to the Company, this aims to encourage Huawei-related staff to improve professional skills in specific area and to maintain competitiveness. In FY4Q21 alone, the Company spent extra RMB196mn staff cost related to this initiative.

If we adjust for the above costs, iSoftStone GPM will be at 26.6% in FY21 (down 0.6 ppts YoY compared to 27.2% in FY20). We expect Chinasoft FY21 gross margin to be at 29.1% (vs. consensus of 29.3%). We are concerned that Chinasoft will also face similar margin decline because of Huawei.

3) 1Q22 demand remains solid but margin decline continues

iSoftStone expects FY1Q22 revenue to grow at +28% YoY to RMB4,554mn while adj. net profit will only grow at +15% YoY to RMB80mn. We are concerned that the extra cost spent on Huawei business is not one-off and it will continue to linger iSoftStone/ Chinasoft margins.

Figure 7: iSoftStone FY21 GPM erosion is largely related to Huawei

2021 年度，公司营业收入为 1,662,320.87 万元，较上年增长 27.88%；公司扣除非经常性损益后归属于母公司所有者的净利润为 86,839.09 万元，较上年有所下滑，主要原因系公司重要客户华为处于战略转型时期，公司基于伴随客户成长的长期发展战略加大相关投入，具体如下：

2021 年度，华为在运营商板块继续保持领先的情况下，大力发展企业板块，包括基于鲲鹏系列服务器和昇腾系列芯片，持续发力云市场；着力恢复消费者板块，包括大力推进鸿蒙系统、云服务生态环境的构建，加大在智能汽车、自动驾驶等领域的布局。2021 年下半年尤其是四季度，华为通过举行“军团”组建成立大会等一系列活动，加快转型升级。

发行人在全年收入迅速提升的基础上，围绕华为的战略转型进一步加强人力成本投入，主要包括：（1）公司围绕华为战略布局的新兴领域，通过现有业务团队技术升级与重点领域人才引进相结合的策略，配合华为进行能力建设和人力投入，全年增加人力成本投入 1.19 亿元；（2）为进一步加强客户黏性，为客户持续提供优质服务，保证项目团队的持续创新能力，2021 年第四季度开始，公司针对服务华为的既有员工推出了专项激励政策，鼓励员工提升专业技能，满足各项新业务领域对专业技术人才的需求，促进技术和业务竞争力持续提升，第四季度增加人力成本投入 1.96 亿元。上述事项合计金额 3.15 亿元。

随着华为转型策略的逐步实施，公司的前期投入将对公司业绩产生积极影响并在未来几年逐步体现，公司的技术积累及上述人力成本的投入将逐步转化为高质量的服务收入，相关技术经验的积累及生态建设将逐步向其他行业客户进行复制、推广或辐射，进一步提升公司服务能力及盈利能力，打造新的利润增长点。

Source: Company data, CMBIGM

Figure 8: iSoftStone FY1Q22E guidance

根据初步测算，公司 2022 年 1-3 月业绩预计情况如下：

单位：万元

项目	2022 年 1-3 月	2021 年 1-3 月	变动幅度
营业收入	455,354.40	355,407.02	28.12%
归属于母公司所有者的净利润	8,761.50	7,825.72	11.96%
扣除非经常性损益后归属于母公司所有者的净利润	8,055.15	6,981.93	15.37%

上述 2022 年 1-3 月业绩预计情况系公司初步测算数据，未经审计或审阅，预计数不代表公司最终可实现营业收入、净利润，亦不构成公司盈利预测。

Source: Company data, CMBIGM

Figure 9: Chinasoft vs. iSoftStone

RMB mn	2017	2018	2019	2020	2021
Revenue					
- Chinasoft	9,244	10,585	12,042	14,101	18,166
...YoY		15%	14%	17%	29%
- iSoftStone	6,990	8,108	10,580	12,981	16,619
...YoY		16%	30%	23%	28%
Revenue from Huawei					
- Chinasoft	4,873	5,620	6,570	8,030	
...YoY		15%	17%	22%	
as % of total revenue	53%	53%	55%	57%	
- iSoftStone	3,775	4,344	5,881	7,218	
...YoY		15%	35%	23%	
...as % of total revenue	54%	54%	56%	56%	
Huawei R&D					
% of Huawei R&D	89,690	101,509	131,659	141,900	
- Chinasoft	5.4%	5.5%	5.0%	5.7%	
- iSoftStone	4.2%	4.3%	4.5%	5.1%	
GPM					
- Chinasoft	29.8%	30.7%	29.8%	29.2%	29.1%
...YoY		0.9%	-0.9%	-0.5%	-0.1%
- iSoftStone	23.0%	24.3%	26.9%	27.2%	24.7%
...YoY		1.3%	2.6%	0.3%	-2.5%
Employees					
- Chinasoft	50,823	62,495	61,380	75,956	
- iSoftStone	38,638	53,973	60,979	75,406	
Revenue per employee					
- Chinasoft	181,880	169,374	196,186	185,650	
- iSoftStone	180,913	150,220	173,498	172,142	

Source: Company data, CMBIGM estimates for Chinasoft FY21

FY21E preview

Figure 10: CMBI estimates vs consensus

RMB mn	2021E			2022E			2023E		
	CMBI	Street	Diff	CMBI	Street	Diff	CMBI	Street	Diff
Sales	18,166	18,059	1%	22,352	22,388	-0%	26,825	27,429	-2%
Gross profit	5,290	5,289	0%	6,483	6,639	-2%	7,768	8,218	-5%
OP Profit	1,003	1,297	-23%	1,308	1,643	-20%	1,618	2,074	-22%
PBT	1,229	1,307	-6%	1,447	1,708	-15%	1,823	2,216	-18%
Net profit	1,143	1,216	-6%	1,356	1,601	-15%	1,696	2,095	-19%
EPS (RMB)	0.37	0.39	-4%	0.43	0.48	-11%	0.54	0.60	-10%
Margins									
GM	29.1%	29.3%	-16 bps	29.0%	29.7%	-65 bps	29.0%	30.0%	-100 bps
OPM	5.5%	7.2%	-166 bps	5.9%	7.3%	-149 bps	6.0%	7.6%	-153 bps
PBT margin	6.8%	7.2%	-47 bps	6.5%	7.6%	-115 bps	6.8%	8.1%	-129 bps
Net margin	6.3%	6.7%	-44 bps	6.1%	7.2%	-108 bps	6.3%	7.6%	-132 bps

Source: Company data, CMBIGM estimates

Figure 11: 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
Revenue breakdown					
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
Huaw ei	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
Growth YoY					
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, CMBIGM estimates

Figure 12: 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
Margins						
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%
Growth(HoH)						
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%
Growth(YoY)						
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, CMBIGM estimates

Valuation

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

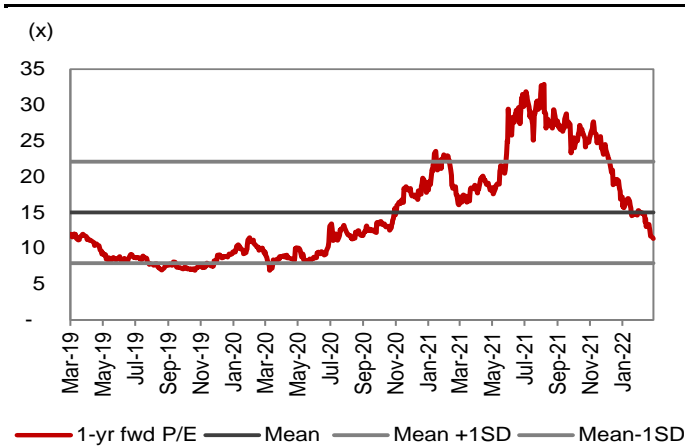
We have BUY rating on Chinasoft with target price of HK\$11.26, based on 23x FY22E fully diluted EPS, in-line with peers average.

Figure 13: Peers' valuation

Company	Ticker	Rating	Mk Cap (US\$ mn)	Price (LC)	TP (LC)	P/E		ROE		Sales CAGR FY20-23	EPS CAGR FY20-23
						FY21E	FY22E	FY21E	FY22E		
Chinasoft	354 HK	BUY	2,465	6.23	11.26	15.1	12.7	12.2	12.9	24%	19%
Digital China	000034 CH	NR	1,557	14.90	N/A	12.4	9.6	14.8	16.3	9%	25%
Infosys	INFO IN	NR	100,166	1816.45	N/A	39.6	34.0	28.4	30.1	16%	18%
Tata Consultancy	TCS IN	NR	175,791	3624.50	N/A	41.0	34.6	38.0	41.2	11%	11%
Mean						28.6	24.0	23.3	25.1	15%	18%
Median						30.4	26.0	21.6	23.2	14%	18%

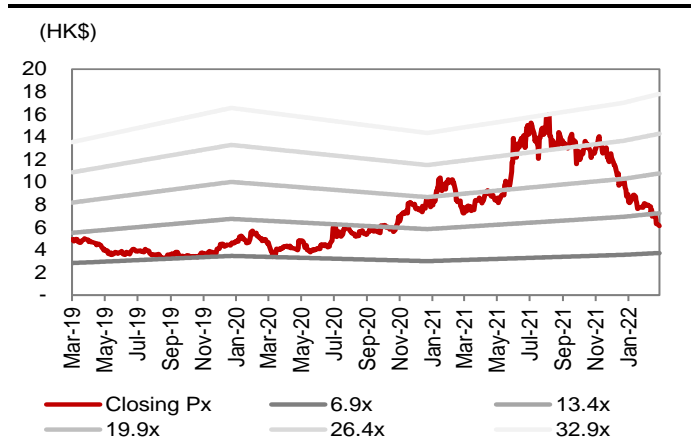
Source: Bloomberg, CMBIGM

Figure 14: 12M forward P/E chart



Source: Company data, CMBIGM

Figure 15: 12M forward P/E band



Source: Company data, CMBIGM

Financial Summary

Income statement						Cash flow summary					
YE 31 Dec (RMBmn)	FY19A	FY20A	FY21E	FY22E	FY23E	YE 31 Dec (RMBmn)	FY19	FY20	FY21E	FY22E	FY23E
Revenue	12,042	14,101	18,166	22,352	26,825	Net profit	799	1,035	1,229	1,447	1,823
Cost of sales	(8,459)	(9,983)	(12,875)	(15,869)	(19,057)	Depreciation/amortization	197	170	109	111	115
Gross profit	3,583	4,118	5,290	6,483	7,768	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)	Net cash from operating	754	1,153	1,327	1,509	1,126
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)
Operating profit	827	952	1,003	1,308	1,618	Net cash from investing	(224)	(192)	(371)	(198)	(196)
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)
Pre-tax profit	799	1,035	1,229	1,447	1,823	Others	(701)	145	(188)	4	4
Income tax expense	(42)	(87)	(87)	(96)	(131)	Net cash from financing	(650)	362	919	(80)	209
Minority interests	2	(7)	(1)	(4)	(4)	Net change in cash	(119)	1,323	1,875	1,232	1,140
Net profit to shareholders	755	955	1,143	1,356	1,696	Cash at beginning of the year	2,646	2,526	3,787	5,758	7,038
						Exchange difference	(1)	(62)	96	48	46
						Cash at the end of the year	2,526	3,787	5,758	7,038	8,223

Balance sheet						Key ratios					
YE 31 Dec (RMBmn)	FY19	FY20	FY21E	FY22E	FY23E	YE 31 Dec	FY19	FY20	FY21E	FY22E	FY23E
Current assets	8,198	10,394	12,865	14,779	17,345	Revenue mix					
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	Growth (%)					
Other current assets	147	123	171	200	229	Revenue	14%	17%	29%	23%	20%
Non-current assets	2,547	2,693	2,979	3,018	3,053	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	Profit & loss ratio (%)					
Total assets	10,745	13,087	15,844	17,797	20,398	Gross margin	29.8%	29.2%	29.1%	29.0%	29.0%
Current liabilities	3,150	2,718	4,746	5,425	6,340	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	Balance sheet ratio					
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
Non-current liabilities	1,062	1,592	1,185	1,184	1,276	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
Total liabilities	4,211	4,311	5,931	6,609	7,616	Profitability (%)					
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	Per share data (RMB)					
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
Total equity	6,534	8,776	9,913	11,188	12,782	BVPS (RMB)	2.45	2.93	3.14	3.54	4.05
Total liabilities and equity	10,745	13,087	15,844	17,797	20,398						

Source: Company data, CMBIGM estimates

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