Kingdee 金蝶国际 (268 HK)

Riding on the momentum of cloud business

The migration from traditional ERP towards cloud brings new opportunity for Kingdee, and the management targets to lift its cloud revenue contribution to 60% by 2020E (25% in 2017). Despite short-term margin pressure from its cloud business, this shift from one-off software license fee towards recurring annual prepaid fee represents stronger cash flow to Kingdee. Our two-stage DCF-based target price of HK$8.40 implies a SOTP valuation of 22x 2018E PER for ERP business plus a 12x 2018E P/S for cloud business, 10% upside. Initiate Accumulate.

- **Cloud business to be key revenue driver.** Kingdee's cloud service revenue surged 75% CAGR in 2014-2017 to reach Rmb568mn in 2017, and we forecast its cloud revenue to grow 45%/55% YoY in 2018E/2019E respectively to reach Rmb824mn/Rmb1277mn. Kingdee is one of the earliest entrants in China SaaS market, and enjoys the largest share in China's SaaS ERM market (18%) and in China's SaaS financial management applications market (44%) in 2017. Kingdee targets its cloud revenue to reach 60% of total revenue by 2020E. We believe future growth will be driven by 1) further penetration of cloud among enterprises in China and 2) strong government support.
- **Traditional ERP still strong in 2018E, to deliver stable growth.** Revenue from traditional ERP business grew strongly by 20% YoY in 1H18, mainly driven by EAS (+28.8% YoY). Software license revenue from KIS and K/3 grew by 13.6% YoY and 14.0% YoY, respectively. Given the uncertainties regarding the macro economy and especially SMEs and the pressure of migration towards cloud, we are taking a relatively conservative view about software license revenue in coming three years, and we forecast its traditional ERP business to grow stably by 15%/5% YoY in 2018E/2019E to reach Rmb1,996mn/Rmb2,095mn, respectively.
- **Short-term margin pressure from cloud; breakeven in 2020E.** As Kingdee puts its first priority of cloud business to gaining new clients and grabbing market share in the beginning years, Kingdee's marketing expense is maintained at >50% of total revenue. It has been suffering net loss from its cloud business since 2015, and we expect it to breakeven by 2020E. On the positive side, the shift of business model from one-off software license fee towards recurring prepaid annual fee brings stronger cash flow.
- **Initiate Accumulate.** We took relatively conservative assumptions about cloud and applied a 20% discount to the management's 2020E guidance in our financial model as it is still at early stage. When the visibility of its cloud business becomes clearer and if it can successfully roll out as the company plans, there will be further upside. As its cloud business is still in loss-making stage, earnings might not fully reflect its future prospect, thus we analyzed the fair value of Kingdee using a two-stage growth DCF valuation method, which suggest HK$8.40 per share. This target also equals a SOTP valuation of 22x 2018E PER for its ERP business plus a 12x 2018E P/S for its cloud business, representing 10% upside. Initiate Accumulate.

Investment Summary

FY-end Dec	2016	2017	2018E	2019E	2020E
Turnover (Rmb mn)	1,862	2,303	2,819	3,372	4,074
Chg (%)	23	24	22	20	21
Net Profit (Rmb mn)	216	337	348	450	605
Chg (%)	(1)	56	3	29	34
EPS (Rmb)	0.10	0.11	0.12	0.16	0.22
Chg (%)	161	11	12	29	34
P/E (x)	35.7	33.2	54.7	42.3	31.5
P/B (x)	2.2	2.7	4.4	4.0	3.6
P/OCF (x)	2.7	2.0	2.4	2.1	1.7
EV/EBITDA (x)	11.6	12.4	25.0	21.6	17.8
DPS (Rmb)	-	0.01	0.14	0.16	0.18
Yield (%)	-	0.4	0.2	0.3	0.8

Source: Company data, Orient Securities (Hong Kong)

Accumulate

Share Price	Target Price
HK$7.65	HK$8.40

China / Technology / Software

19 November 2018

Elsie Sheng (SFC CE: AWT319)
(852) 3519 1056
elsie.sheng@dfzq.com.hk

Latest Key Data

Total shares outstanding (mn)	3,297
Market capitalization (HK$mn)	25,221
Enterprise value (HK$mn)	22,730
12M daily turnover (HK$mn)	264.3
12M volatility (%)	63.8
PEG FY17-19E (X)	2.7
RoE avg FY17-19E (%)	9.0
P/B FY18E (x)	4.4
Net debt/equity FY18E (%)	Net Cash

Performance (%)

	1M	YTD	12M
Absolute	14	74	73
Relative to HSI	11	86	83

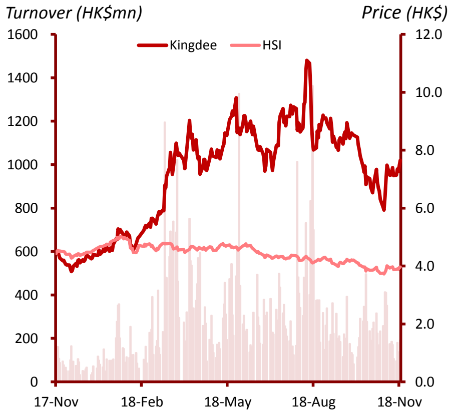
Major Shareholders (%)

Xu Shao Chun	24
The Capital Group	9

Auditor

PricewaterhouseCoopers

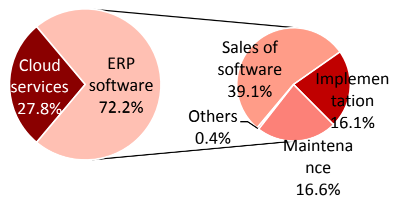
Price Chart



Source: Bloomberg, Orient Securities (Hong Kong)

Leading ERP software developer and cloud platform in China

Figure 1: Kingdee 1H18 revenue breakdown

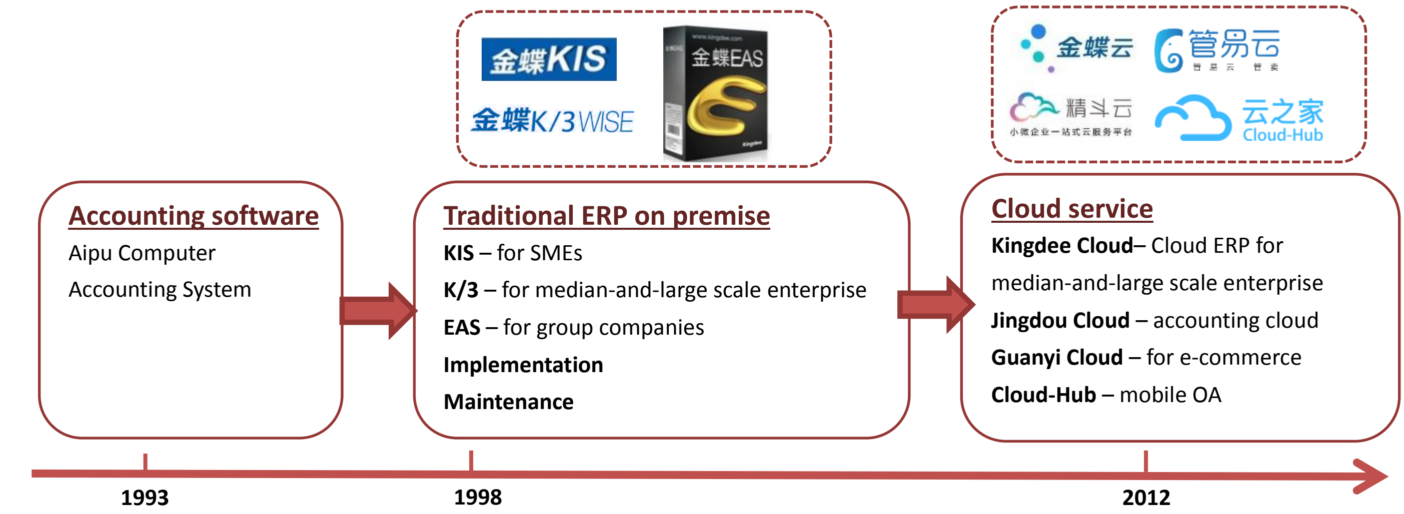


Source: Company data, Orient Securities (Hong Kong)

A well-known traditional ERP provider and market leader in China enterprise SaaS

Established in 1993 as an accounting software developer, Kingdee started to provide ERP (Enterprise Resource Planning) software since 1998 and began to transform towards a cloud platform company since 2012. Kingdee provides different types of ERP products for different types of companies among different industries, and has successfully expanded its coverage from traditional ERP to cloud (27.8% of 1H18 revenue). Kingdee is now leading China's enterprise SaaS (Software as a Service) market, and owns the largest market share (18%) in China's SaaS ERM market in 2017 and dominating share (44%) in China's SaaS financial management applications market.

Figure 2: Development history of Kingdee



Source: Company data, Google Image, Orient Securities (Hong Kong)

Traditional ERP to provide solid base with recovery since 2016

Traditional ERP market in China has entered mature stage and a migration from offline ERP towards cloud has taken place since 2012, which implies slower growth from traditional ERP business. The sales growth of ERP software in China did slowed in 2014-2015 (Kingdee's ERP business revenue declined 6.8% and 6.4% YoY respectively in 2014-15), but the market resumed growth again since 2016, and Kingdee's ERP business revenue grew 12.8% YoY and 14.1% YoY in 2016 and 2017 respectively. As the usual life cycle of offline ERP is 3-5 years, existing clients of traditional ERP will continue to provide a solid base for Kingdee.

Figure 3: Kingdee shareholder structure

Source: Company data, Orient Securities (Hong Kong)

Cloud as the key revenue growth driver in coming three years

As the first mover in China enterprise SaaS market as early as 2012, Kingdee has enjoyed high growth of its cloud business (Kingdee's cloud service revenue surged 75% CAGR in 2014-2017), and cloud will be the most important growth driver for Kingdee in coming three years. The revenue contribution from cloud services has jumped quickly from only 4% in 2013 to 27.8% in 1H18. The company guides revenue contribution of cloud to continue to climb to >30% for 2018E and >60% in 2020E.

Founder and Chairman as the largest shareholder

The shareholder structure of Kingdee is relatively diversified. Mr. Xu ShaoChun, the founder and Chairman of Kingdee, is the largest shareholder of Kingdee owning 24.3% share of total. The Capital Group owns the second largest share (9.2%).

Cloud ERP: lower cost for enterprises than traditional ERP

Figure 4: Cloud ERP can be accessed from various terminals through internet

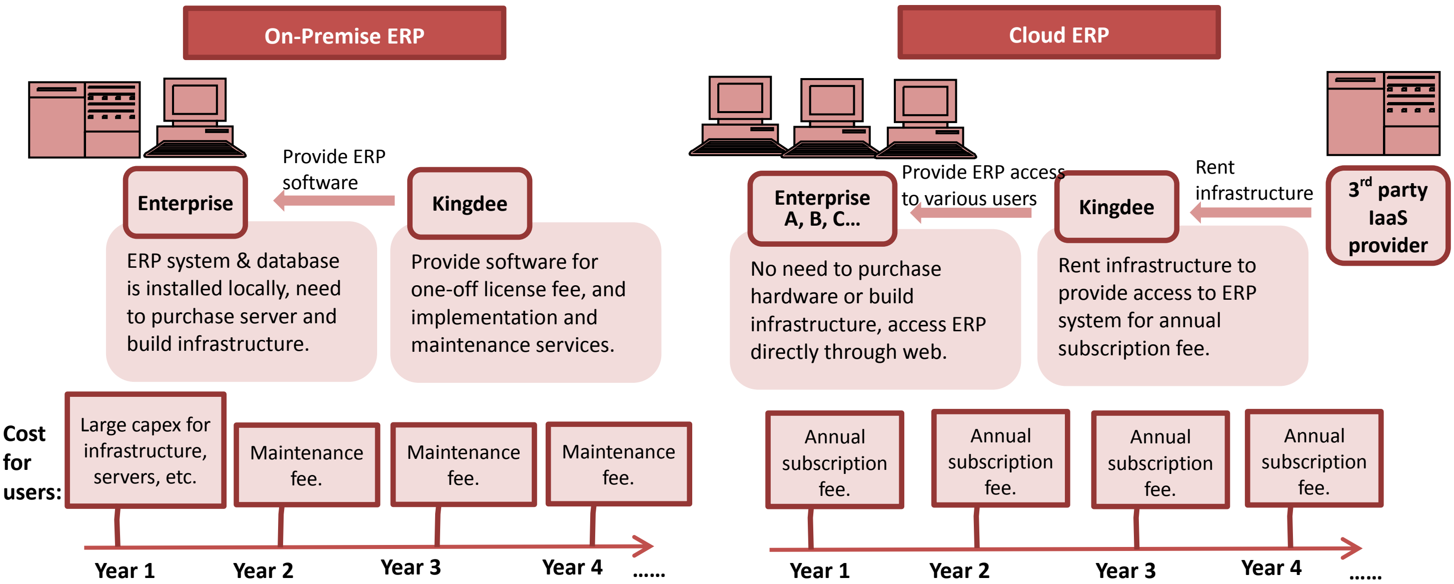
Source: Kingdee, Orient Securities (Hong Kong)

Different structures between traditional ERP and cloud ERP

ERP is business management software that helps enterprises to efficiently monitor and manage business processes by collecting, storing and analyzing data from daily business activities like accounting, project management and manufacturing. It enables enterprises to do better order tracking, inventory optimization, revenue tracking, etc. Traditional on-premise ERP is installed locally at client's hardware and servers, and is usually priced at a one-time license fee. The client will need to purchase related software and hardware, servers, build infrastructures and recruit IT staff.

On the other hand, cloud ERP is hosted on the service provider's (like Kingdee's) server, and the client thus doesn't have to purchase related hardware and infrastructure, but rather pay an annual subscription fee to access the ERP system (like web browser).

Figure 5: Different models of offline on-premise ERP and Cloud ERP



Source: Orient Securities (Hong Kong)

Cloud ERP can help enterprises to reduce ~70% of cost, especially in the beginning years.

Lower cost for enterprise to adopt cloud ERP, stronger cash flow for service provider

Since cloud ERP does not require large upfront capex for building infrastructure, it is much cheaper than traditional ERP (can reduce ~70% of cost), especially in the beginning years. Thus traditional ERP is more suited for large-sized enterprises with higher budget or existing infrastructure, while cloud ERP is suited for SMEs with lower budget.

From the service providers' point of view, cloud ERP generates recurring income each year with prepaid payment, and thus it brings stronger cash flow.

Figure 6: Comparison between traditional ERP and Cloud ERP

	Traditional ERP	Cloud ERP
Revenue	One-off	Recurring
Service fee renewal rate	20-30%	80%+
Frequency of customer contact	One-off	Constant
Upsell opportunities for Value Added Services	Median	High
Customer payment cycle	Based on delivery	Prepaid
Discounts offered to customers	High	Low or none
Opportunities for price adjustments	Low	High

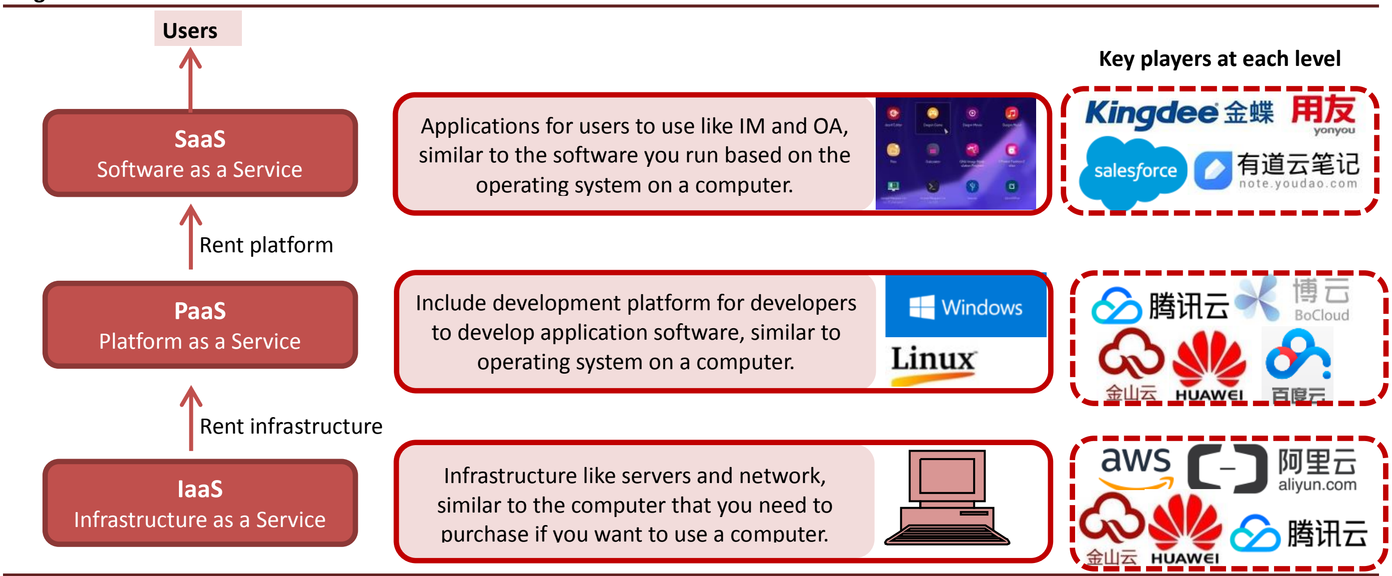
Source: Kingdee, Orient Securities (Hong Kong)

Three levels of cloud service and key players

Three levels of cloud service

Cloud computing is the technology of shared pools of computer system resources and cloud service is made available to all users on demand over the internet from a cloud computing provider's server. The cloud service can be divided into three layers, i.e. SaaS (Software as a Service), PaaS (Platform as a Service) and IaaS (Infrastructure as a Service). SaaS directly face end-users and IaaS provide the underlying infrastructure.

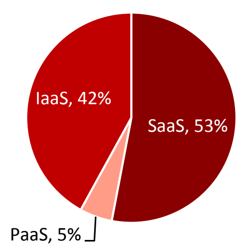
Figure 7: Different levels of cloud service



Source: iResearch, Orient Securities (Hong Kong)

Kingdee is a SaaS and PaaS player, and it cooperates with IaaS like AWS and Huawei Cloud to rent infrastructure. Many SaaS players and IaaS players also penetrates into the role of PaaS providers, and thus there's not much big pure PaaS players. IaaS market in China is led by internet companies like Alibaba, Tencent, Kingsoft, etc. SaaS is the closest to end-users, thus SaaS players need to provide differentiating user experiences to attract users. According to data from iResearch, SaaS is the largest subsector of public cloud market in China by market value. SaaS products can be divided by various categories of application, and Kingdee mainly provides ERP cloud, OA cloud and Finance cloud.

Figure 8: Breakdown of public cloud market in China 2016



Source: iResearch, Orient Securities (Hong Kong)

Figure 9: Key SaaS players in China by category (products of Kingdee circled in red)

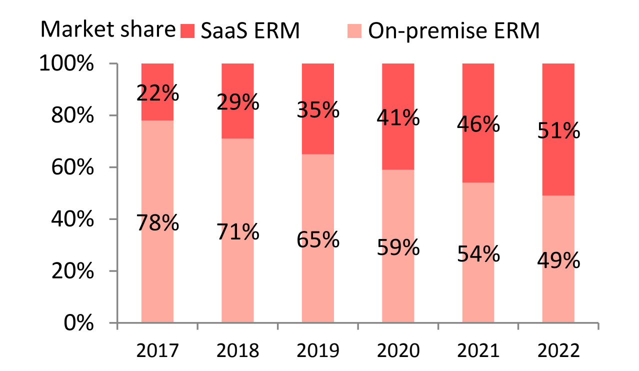
Source: iResearch, Orient Securities (Hong Kong)

Industry trend of shifting from offline ERP towards cloud ERP

Offline ERP towards online cloud- trend of de-IOE

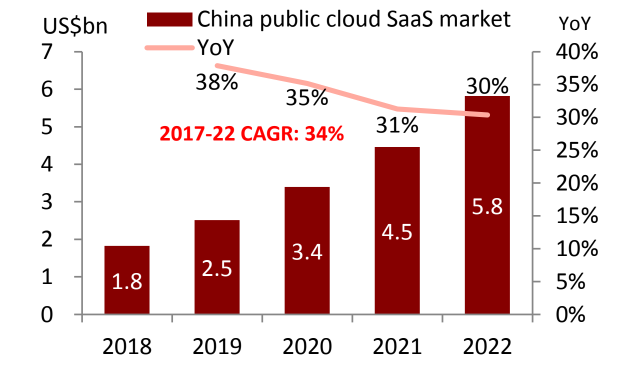
Traditional ERP market began in 2000s and entered growth period in 2009-2012 with >20% annual growth rate as enterprises in China started to realize the importance of adopting ERP. Growth started to slow since 2013 as traditional ERP entered mature stage and cloud ERP started to emerge. SaaS industry in China began around 2012 and started to enter fast-growth period since 2015, and this shift from traditional ERP towards cloud ERP will continue with percentage of SaaS ERM expected to reach 51% by 2022 according to IDC. This will push a 41% 2017-2020 CAGR of China enterprise SaaS market value.

Figure 10: SaaS gradually replaces on-premise ERM in China



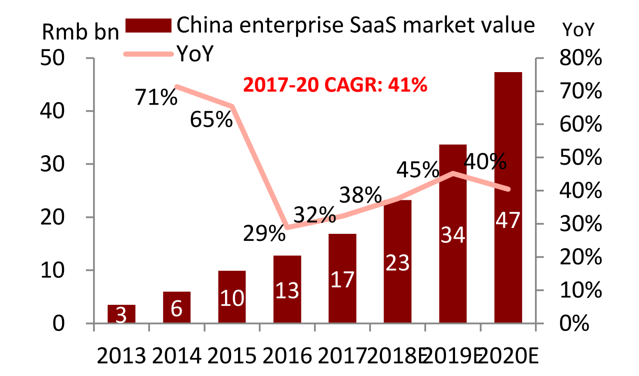
Source: IDC, Orient Securities (Hong Kong)

Figure 11: China public cloud SaaS market forecast



Source: IDC, Orient Securities (Hong Kong)

Figure 12: China enterprise SaaS market value



Source: iResearch, Orient Securities (Hong Kong)

Figure 13: Policies in China relating to cloud development

Time	Department	Details
2015	State Council	Opinions on promoting cloud computing innovation and cultivating new business forms of the information industry, "Internet Plus"
2017	Ministry of Industry and Information Technology	Three-year action plan of cloud computing development (2017-2019)
2018		Implementation guidelines for promoting enterprises to adopt cloud 2018-2020

Source: Public release, Orient Securities (Hong Kong)

Growth of enterprise SaaS in China will be driven by 1) increasing demand from enterprise of de-IOE and digitalization, and 2) government support.

De-IOE is a concept initiated by Alibaba of replacing traditional hardware represented by IBM (mainframe), Oracle (database) and EMC (storage device) by cloud computing technology.

Adopting cloud can save enterprises the cost of purchasing expensive hardware.

Strong government support for cloud development in China

Chinese government has been very active in promoting corporate cloud migration in China in all industries to follow the trend of Internet+. In 2015, the State Council published *Opinions on promoting cloud computing innovation and cultivating new business forms of the information industry*, targeting to make the cloud computing application generally universal by 2020 and providing taxation policy and financing policy support. In 2017, the Ministry of Industry and Information Technology issued *Three-year action plan of cloud computing development (2017-2019)* and expected the cloud computing industry value to reach Rmb430bn by 2019. This year, the Ministry of Industry and Information Technology issued *Implementation guidelines for promoting enterprises to adopt cloud (2018-2020)*, and in the guidelines the government demanded that the number of newly added enterprises adopting cloud in China to reach 1mn by 2020.

Kingdee achieved leading position in SaaS ERP in China

Kingdee offers a wide range of cloud products targeting different types of clients, and has achieved leading position in China.

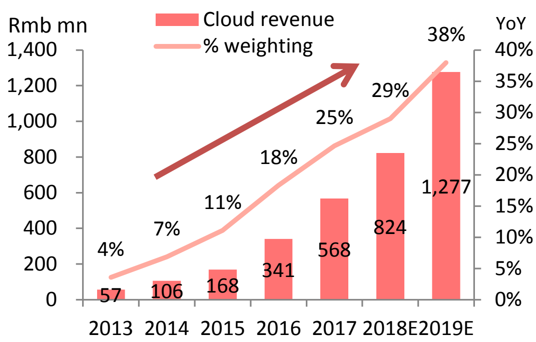
Kingdee enjoys first mover advantage

Kingdee launched its Cloud-Hub mobile OA platform in 2014 and started to transform towards cloud. Kingdee's cloud service revenue has surged 75% CAGR in 2014-2017 to reach Rmb568mn in 2017. It is the earliest entrant of cloud market in China, and enjoys the largest share in China's SaaS ERM market (18%) and in China's SaaS financial management applications market (44%) in 2017, according to IDC. Kingdee offers a wide range of cloud products including: Kingdee Cloud (for mid-to-large-size enterprise), Jingdou Cloud (for SMEs), Cloud-Hub (mobile OA platform), Guanyi Cloud (for e-commerce industry), and Che Shangyue (for auto agencies), etc. Kingdee targets its cloud revenue to reach 60% of total revenue by 2020, and future growth will be driven by 1) further penetration of cloud among enterprises in China and 2) government support.

Figure 14: Kingdee's transformation towards Cloud

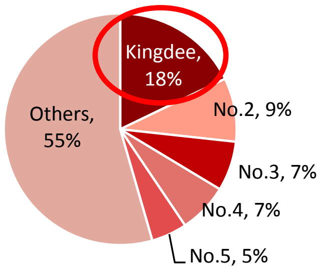
Source: Company, Orient Securities (Hong Kong)

Figure 15: Kingdee's cloud revenue forecast



Source: Company, Orient Securities (Hong Kong)

Figure 16: China SaaS ERM market share 2017



Source: IDC, Orient Securities (Hong Kong)

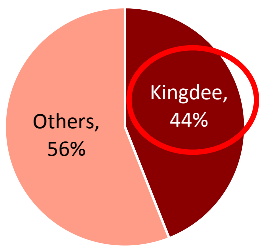
Riding on the penetration of cloud service into corporates

The developments of cloud in China lag behind US for around five years. US SaaS industry has entered mature stage since 2015, while the penetration of cloud among enterprises in China is still at early stage. According to a survey by CAICT, 57.6% of the companies plan to increase their spending in public cloud in coming three years, and 21.7% will increase their spending by over 50%, implying big potential market. And over 80% of the companies are inclined to choose domestic cloud service providers; this will favor domestic players like Kingdee.

Benefiting from government's favorable policy

Kingdee Cloud is shortlisted by eight municipal governments as the recommended corporate cloud services provider, and pending local government's review in another nine provinces. In Hunan province, over 50% of enterprises in the government's first benchmarking list are using Kingdee cloud services.

Figure 17: China SaaS financial management applications market share 2017



Source: IDC, Orient Securities (Hong Kong)

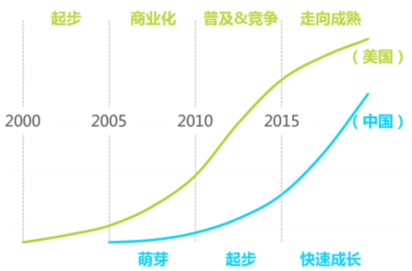
Figure 18: Kingdee's cloud client base

Source: iResearch, Orient Securities (Hong Kong)

Peer comparison

China SaaS market started to enter fast-growth period since 2015, while the US SaaS market has already entered mature stage since then. Thus we compare Kingdee with emerging domestic SaaS players like Yonyou in China and we also show below the more mature overseas players in the US.

Figure 19: Different development stage of SaaS industry in US and China



Source: IDC, Orient Securities (Hong Kong)

Domestic peers

Yonyou is a close competitor of Kingdee in the domestic market. Like Kingdee, Yonyou also transformed from a traditional enterprise software company towards cloud, but not as early as Kingdee. Although Yonyou has a larger total revenue size than Kingdee, Kingdee has larger cloud revenue size than Yonyou. Chanjet is a subsidiary of Yonyou that targets specifically SMEs.

Figure 20: Comparison between traditional ERP and Cloud ERP

	Kingdee	Yonyou	Chanjet
Stock code	268 HK	600588 CH	1588 HK
Structure	Shift from offline towards cloud	Shift from offline towards cloud	Subsidiary of Yonyou serving SMEs
Cloud product offering	Cloud ERP for mid-to-large-size enterprise, cloud for SMEs, mobile OA platform, e-commerce cloud, auto agency industry cloud, etc.	Cloud ERP, financial cloud, cloud for various industries like manufacturing, healthcare, etc.	Accounting cloud for SME, e-commerce cloud, cloud ERP for retail/distributor, mobile OA.
Client	All types of companies	All types of companies	Mainly SMEs
2017 Cloud revenue	Rmb568mn	Rmb409mn	Rmb25mn
2018E Revenue	Rmb2,819mn	Rmb8,207mn	Rmb472mn
Revenue YoY	22.4%	31.3%	-5.3%
2018E GP margin	81.4%	70.9%	93.0%
2018E NP margin	12.3%	8.3%	17.6%
2017 Marketing exp. %	53.7%	19.9%	33.0%

Source: Kingdee, Orient Securities (Hong Kong)

Overseas players

The SaaS companies in the US can be grouped into two categories, 1) pure SaaS providers like Salesforce, and 2) traditional software companies transforming towards cloud like Adobe.

Figure 21: Comparison between traditional ERP and Cloud ERP

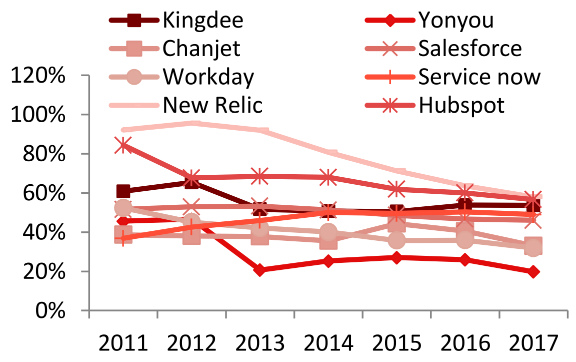
	Stock code	Market cap	Area	FY18 Revenue	FY18 Net margin
SaaS providers					
Salesforce	CRM US	US$100.3bn	CRM	US$13.2bn	1.2%
Workday	WDAY US	US$29.1bn	HRM	US$2.1bn	-15.0%
Service Now	NOW US	US$30.7bn	ITSM	US$2.6bn	-1.3%
Athenahealth	ATHN US	US$5.3bn	Healthcare	US$1.3bn	8.9%
New Relic	NEWR US	US$4.8bn	APM	US$355mn	-12.8%
Hubspot	HUBS US	US$5.3bn	Marketing automating	US$506mn	-12.8%
Box	BOX US	US$2.5bn	EFSS	US$506mn	-30.6%
Traditional software companies transform towards cloud					
Adobe	ADBE US	US$116.6bn	Graphic	US$9.0bn	29.8%
Autodesk	ADSK US	US$29.3bn	Architecture	US$2.1bn	-27.6%
SAP	SAP	US$125.3bn	ERM	US$24.8bn	17.0%

Source: Kingdee, Orient Securities (Hong Kong)

Financials – typical patterns of SaaS company

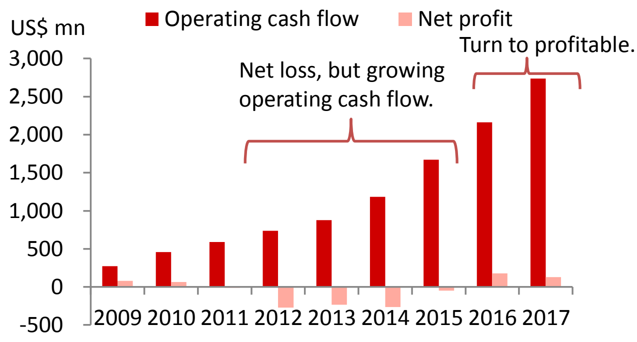
Typically, SaaS companies need to spend high level of sales and marketing expenses to continuously add new clients so as to maintain high revenue growth rate in the beginning years, and this would drag down its net profit margin. A traditional ERP company transforming towards cloud would typically experience a decline in net profit or even would experience net loss in the beginning years as the company would need to spend heavily into marketing expenses (usually >50% of revenue) to grab market share, but cash flow will become quite strong as the revenue is shifted from one-off purchase to prepaid recurring revenue. After the transformation period, net profit margin will start to improve but revenue growth will also slow down to a stable growth (retention rate of SaaS customers are usually high). These characteristics can be observed from mature US companies like Salesforce.

Figure 22: SaaS company marketing expenses % of revenue



Source: Company, Orient Securities (Hong Kong)

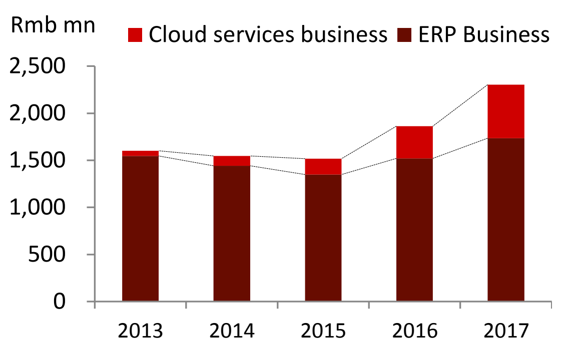
Figure 23: Salesforce's operating cash flow & net profit



Source: Company, Orient Securities (Hong Kong)

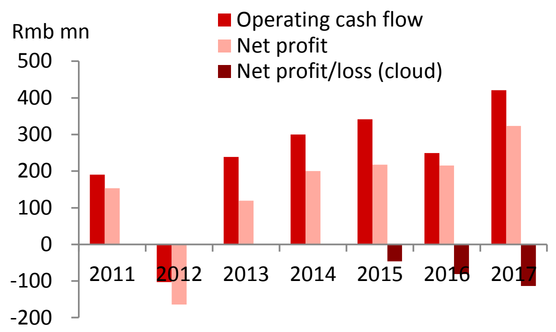
We observed that Kingdee also follows this pattern. As Kingdee's revenue contribution of cloud business started to grow since 2015, marketing expense has been >50% of total revenue. It has been suffering net loss from its cloud business since 2015 (which was compensated by the net profit from its traditional ERP business), while its operating cash flow has been very strong. As its cloud business continues to grow, we expect it to continue invest heavily into marketing expenses, but net profit margin will gradually improve in later years. We observed that it usually take around five years for US SaaS company to turn profitable, and we will apply this to our earnings forecast.

Figure 24: Revenue mix of Kingdee



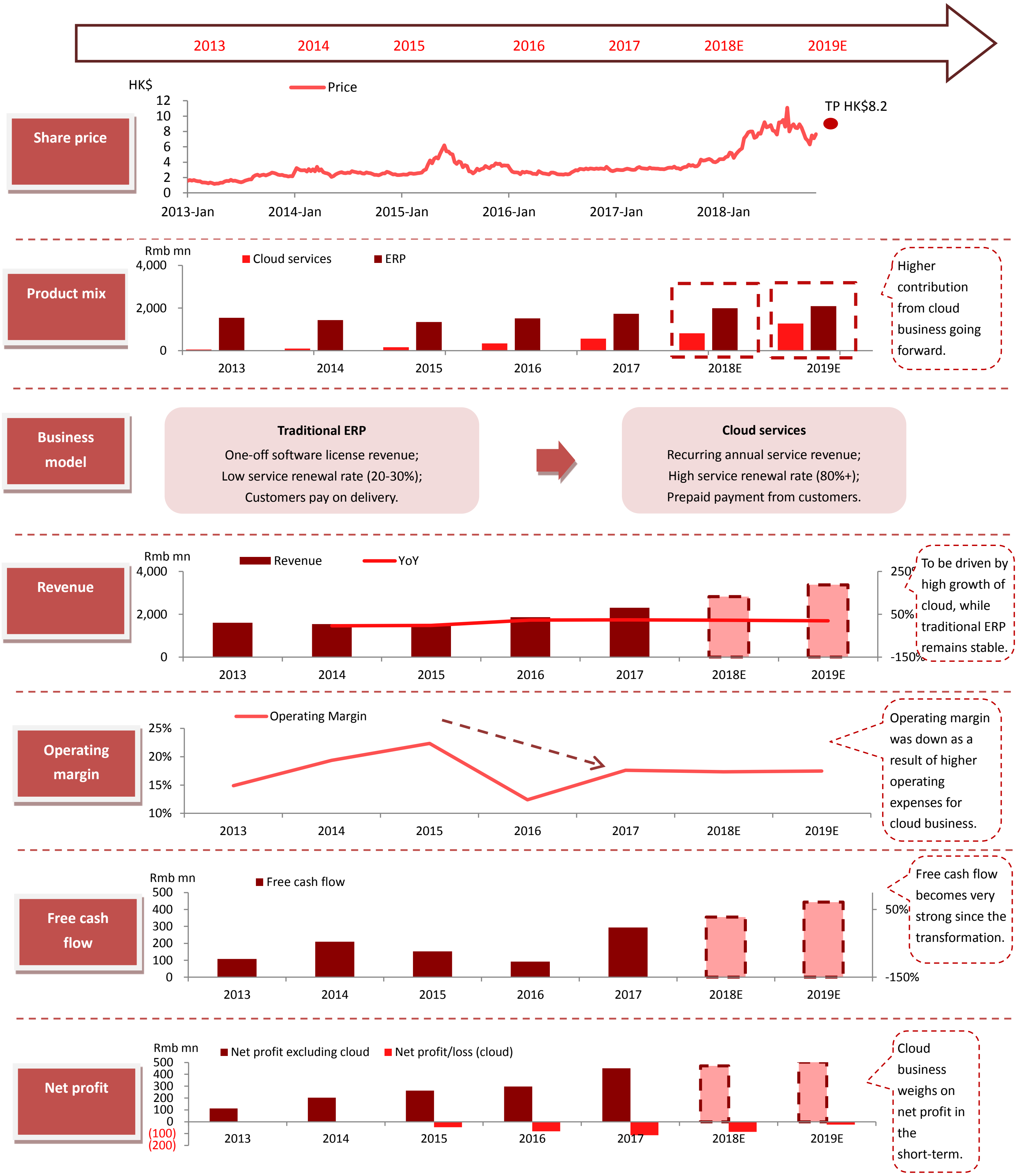
Source: Company, Orient Securities (Hong Kong)

Figure 25: Kingdee's operating cash flow & net profit



Source: Company, Orient Securities (Hong Kong)

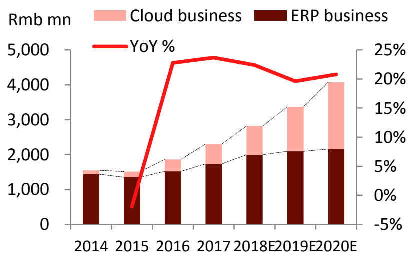
Transition towards a cloud-driven business



Future growth to be driven by cloud business

We forecast Kingdee to deliver 22.4%/19.6% YoY growth in its 2018E/2019E revenue to reach Rmb2.8bn/3.4bn, and a 12.3%/13.3% YoY change in 2018E/2019E net profit to reach Rmb348mn/450mn. Particularly, we expect its cloud business to start making profit in 2020E.

Figure 26: Kingdee's revenue forecast



Source: Company data, Orient Securities (Hong Kong)

Traditional ERP business: to remain stable growth

Revenue from traditional ERP business grew strongly by 20% YoY in 1H18, mainly driven by EAS (+28.8% YoY), i.e. demand from large group enterprises. Software license revenue from KIS and K/3, representing the demand from SMEs and median-sized enterprises, grew by 13.6% YoY and 14.0% YoY, respectively. Given the uncertainties regarding the macro economy and especially SMEs and the pressure of migration towards cloud, we are taking a relatively conservative view about software license revenue in coming three years, and we forecast its traditional ERP business to grow stably by 15%/5% YoY in 2018E/2019E to reach Rmb1,996mn/Rmb2,095mn, respectively.

Figure 27: Kingdee's traditional ERP revenue

Rmb mn	2016	2017	2018E	2019E
Traditional ERP revenue	1,521	1,735	1,996	2,095
YoY change	13%	14%	15%	5%
Weighting of total revenue	82%	75%	71%	62%

Source: Company, Orient Securities (Hong Kong)

Cloud business: to grow 45% YoY in 2018E and to breakeven in 2020E

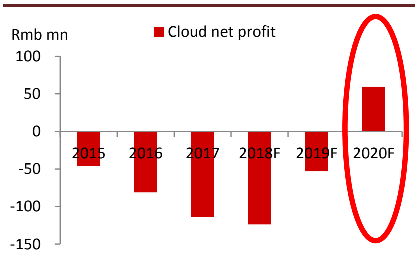
Kingdee Cloud has maintained a retention rate of >80% and has accumulated >7500 customers by 1H18 (88% of Kingdee Cloud Galaxy's customers are new to Kingdee). This August, Kingdee also launched second version of Kingdee Cloud (Kingdee Cloud Comics) to provide more flexible and integrated innovation driven SaaS and PaaS service to super big client, and this new product has attracted over 10 big clients. We believe this will drive new growth for its cloud business, and we forecast its revenue from cloud to grow 45%/55% YoY in 2018E/2019E respectively to reach Rmb824mn/Rmb1277mn.

Figure 28: Kingdee's cloud revenue

Rmb mn	2016	2017	2018E	2019E
Cloud revenue	341	568	824	1,277
YoY change	103%	67%	45%	55%
Weighting of total revenue	18%	25%	29%	38%

Source: Company, Orient Securities (Hong Kong)

Figure 29: Kingdee cloud business to breakeven in 2020E



Source: Company data, Orient Securities (Hong Kong)

The company targets for its cloud revenue to contribute 60% of total revenue by 2020E, while we are taking a ~20% discount to factor in uncertainties and we forecast cloud revenue to account for 47% of total revenue by 2020E in our model. Given the company's cloud strategy to put gaining market share at the first place instead of making profit, in our model we conservatively assume its cloud business to start breakeven staring 2020E.

Given the company's aggressive plan to continue gain market share in its cloud business, we expect its selling and distribution expenses to remain at high level in coming three years (53.5%/52.0%/51.0% of total revenue in 2018E/2019E/2020E). We also assumed stable weighting of R&D expenses and administrative expenses as a percentage of total revenue. Overall we expect mild improvement in its net margin from 12.3% in 2018E to 13.3%/14.9% in 2019E/2020E.

Initiate Accumulate on the prospect of cloud business

Two-stage DCF-based valuation suggest HK$8.4

As its cloud business is still in loss-making stage, earnings might not fully reflect its future prospect, and cash flow and P/S might be a more suitable valuation method. We analyzed the fair value of Kingdee using a two-stage growth DCF valuation method, which suggest HK$8.40 per share. Firstly, we forecast income statement and balance sheet in 2018E-2021E with details in below table. Secondly, we assumed 25% annual growth rate of free cash flow for the period between 2021E -2026E, as compared to 5-year CAGR of 43.8% in 2016-2021E. Then, we assumed a terminal growth rate of 5% for the period beyond 2026E. We used a WACC of 12.0%, and assumed a HKDRMB exchange rate of 0.85.

Figure 30: Assumptions of Kingdee's DCF model

WACC	12.0%
2021-2026 annual growth rate	25%
Terminal growth rate	5%
PV of Terminal value (Rmb mn)	16,163
Total PV of FCF (Rmb mn)	**22,480**
Net Cash/Debt (Rmbmn)	1,358
Target price (HK$)	**8.4**
Upside potential	10%

Source: Company data, Orient Securities (Hong Kong)

This target of HK$8.40 also equals a SOTP valuation of 22x 2018E PER for its ERP business plus a 12x 2018E P/S for its cloud business, which is reasonable.

Figure 31: Kingdee's two-stage DCF model

Rmb$mn	2018E	2019E	2020E	2021E		2026E
Pre-tax income	407	528	710	934		
Tax paid	(59)	(78)	(105)	(139)		
Depreciation & Amortization	362	375	389	403		
Change in Working Capital	(10)	(12)	(12)	(18)		
Capex	(382)	(397)	(412)	(428)		
Free Cash flow (HK$mn)	**374**	**489**	**670**	**884**		**2,697**

Source: Company, Orient Securities (Hong Kong)

25% annual growth rate

Initiate Accumulate

We think the biggest driver for Kingdee is its cloud business, for which we have taken relatively conservative assumptions and have applied a 20% discount to the management's 2020E guidance in our model as it is still at early stage. The biggest risk is economic slowdown hurting enterprises' IT budget. When the visibility of its cloud business becomes clearer and if it can successfully roll out as the company plans, there will be further upside. Our HK$8.4 target represents 10% upside. Initiate Accumulate.

Figure 32: Valuation Comparison

Company	Bloomberg Code	Rating	Price (Local Ccy)	Target (HK$)	Mkt Cap (HK$bn)	PER (x) 17A	PER (x) 18E	PER (x) 19E	PEG (x) 17-19E	P/S (x) 18E	P/B (x) 18E	Yield (%) 18E	ROE (%) 17A	Net Gearing (%) 17A
HK-listed														
Kingdee	268 HK	Accumulate	7.65	8.40	25.2	33.2	54.7	42.3	2.7	6.7	4.4	0.2	8.3	Net cash
Chanjet	1588 HK	Not Rated	8.06	-	1.8	8.5	18.8	17.9	1.6	3.3	1.3	0.0	22.1	Net cash
Chinasoft	354 HK	Not Rated	4.77	-	11.6	18.3	14.5	11.6	0.5	0.9	1.8	0.4	12.0	Net cash
Sinosoft	1297 HK	Not Rated	2.31	-	2.8	9.9	9.5	7.9	0.5	3.5	1.8	1.6	20.7	Net cash
Digital China	861 HK	Not Rated	3.9	-	6.5	-	19.5	15.3	0.2	0.4	-	0.6	-5.1	27.4
Average						**17.5**	**23.4**	**19.0**	**1.1**	**3.0**	**2.3**	**0.6**	**11.6**	
China & US -listed														
Yonyou	600588 CH	Not Rated	26.47	-	57.2	78.3	75.4	54.8	1.3	6.2	7.8	0.6	6.7	Net cash
Salesforce	CRM US	Not Rated	132.55	-	785.4	322.6	52.7	48.5	-	7.6	6.9	0.0	2.9	Net cash
Workday	WDAY US	Not Rated	134.23	-	228.1	-	125.9	89.1	0.7	10.5	16.5	0.0	-30.7	Net cash
ServiceNow	NOW US	Not Rated	171.09	-	240.2	-	72.4	54.6	1.7	11.8	25.8	0.0	-30.7	Net cash
Adobe	ADBE US	Not Rated	238.89	-	913.1	53.3	35.0	29.9	1.7	13.0	11.0	0.0	21.3	Net cash
SAP	SAP US	Not Rated	104.6	-	1006.2	-	20.8	18.7	-	4.7	-	1.5	15.5	9.6
Average						**151.4**	**63.7**	**49.3**	**1.3**	**8.9**	**13.6**	**0.4**	**-2.5**	

Source: Bloomberg, Orient Securities (Hong Kong)

Financial statements & forecasts

Income Statement (consolidated)

FY-end Dec (Rmb mn)	2016	2017	2018E	2019E	2020E
Revenue	**1,862**	**2,303**	**2,819**	**3,372**	**4,074**
ERP business	1,521	1,735	1,996	2,095	2,158
Cloud services business	341	568	824	1,277	1,916
Cost of sales	**(348)**	**(427)**	**(526)**	**(624)**	**(750)**
Gross profit	**1,514**	**1,876**	**2,294**	**2,748**	**3,324**
Other income	264	349	423	438	530
Other gains and losses	34	96	-	-	-
Selling and marketing expenses	(1,002)	(1,236)	(1,508)	(1,754)	(2,078)
Administrative expenses	(278)	(320)	(338)	(388)	(468)
R&D expenses	(284)	(345)	(409)	(472)	(550)
Operating Profit	**249**	**421**	**461**	**573**	**757**
Finance cost	(22)	(27)	(36)	(28)	(31)
Share of profits of associates	(18)	(15)	(18)	(17)	(17)
Profit before tax	**209**	**378**	**407**	**528**	**710**
Income tax expenses	6	(55)	(59)	(78)	(105)
Minorities	1	14	-	-	-
Net profit	**216**	**337**	**348**	**450**	**605**
EBITDA	**595**	**767**	**806**	**932**	**1,129**
EBIT	**231**	**406**	**443**	**556**	**741**
EPS (Rmb)	**0.10**	**0.11**	**0.12**	**0.16**	**0.22**
DPS (Rmb)	**-**	**0.013**	**0.016**	**0.022**	**0.057**

Cash Flow (consolidated)

FY-end Dec (Rmb mn)	2016	2017	2018E	2019E	2020E
Pre-tax profit	209	378	407	528	710
Taxes paid	6	(55)	(59)	(78)	(105)
Depreciation	43	45	28	27	26
Amortization	321	317	334	348	362
Change in working capital	(11)	(12)	(10)	(12)	(12)
Others	68	191	(0)	-	-
Operating cash flow	**637**	**864**	**700**	**813**	**981**
CAPEX	(476)	(379)	(382)	(397)	(412)
Disposals	9	2	3	3	3
Others	(118)	(634)	(94)	(98)	(103)
Investing cash flow	**(586)**	**(1,011)**	**(473)**	**(492)**	**(513)**
Change in debt	(37)	(80)	(150)	(25)	(20)
Dividends paid	-	-	(35)	(45)	(60)
Others	(87)	(156)	-	-	-
Financing cash flow	**(125)**	**(236)**	**(185)**	**(70)**	**(80)**
Free cash flow	**160**	**485**	**318**	**416**	**569**
Net cash flow	(74)	(383)	42	251	388

Semi-Annual Breakdown

FY-end Dec (Rmb mn)	2H16	1H17	2H17	1H18	2H18E
Revenue	**949**	**1,055**	**1,249**	**1,279**	**1,540**
Gross profit	790	845	1,032	1,026	1,268
Operating profit	146	126	295	167	294
Pre-tax profit	126	110	268	170	237
Tax	(36)	(5)	(50)	(11)	(48)
Net profit	**90**	**105**	**219**	**158**	**190**
Gross margin (%)	83.2	80.1	82.6	80.2	82.3
Operating margin (%)	15.4	11.9	23.6	13.1	19.1
Effective tax rate (%)	28.4	4.7	18.5	6.6	20.1
Net margin (%)	9.5	9.9	17.5	12.4	12.3
EPS (Rmb)	0.14	0.04	0.07	0.06	0.06
DPS (Rmb)	-	-	0.01	-	0.02

Source: Company data, Orient Securities (Hong Kong)

Balance Sheet (consolidated)

FY-end Dec (Rmb mn)	2016	2017	2018E	2019E	2020E
Current assets	**2,957**	**3,534**	**3,590**	**3,858**	**4,264**
Cash and cash equivalents	2,216	2,549	2,591	2,842	3,231
Inventories	6	14	17	21	25
Trade, bills and other receivables	147	151	162	176	189
Other current assets	587	819	819	819	819
Non-current assets	**3,021**	**3,268**	**3,379**	**3,496**	**3,620**
Fixed Assets	922	580	563	547	532
Intangible asset	775	817	851	885	922
Other non-current assets	1,324	1,872	1,965	2,063	2,167
Total assets	**5,977**	**6,802**	**6,969**	**7,354**	**7,884**
Current liabilities	**923**	**1,405**	**1,378**	**1,358**	**1,343**
Trade, bills and other payables	19	19	23	27	32
Short-term borrowings	81	155	124	99	79
Other current liabilities	823	1,231	1,231	1,231	1,231
Non-current liabilities	**1,518**	**1,354**	**1,235**	**1,235**	**1,235**
Deferred tax liability	103	161	161	161	161
Long-term debt	1,416	1,194	1,074	1,074	1,074
Other non-current liabilities	-	-	-	-	-
Total liabilities	**2,441**	**2,759**	**2,613**	**2,592**	**2,578**
Share Capital	1,838	1,753	1,753	1,753	1,753
Share premium and reserves	1,698	2,290	2,603	3,008	3,553
Total equity	**3,536**	**4,043**	**4,356**	**4,761**	**5,306**
Total liabilities & equity	**5,977**	**6,802**	**6,969**	**7,354**	**7,884**
Net cash/(debt)	720	1,201	1,393	1,669	2,077
Working capital	2,034	2,129	2,212	2,500	2,921
Total capital employed	5,055	5,397	5,591	5,996	6,540
Net gearing (%)	NC	NC	NC	NC	NC
BVPS (Rmb)	**3.272**	**1.440**	**1.551**	**1.696**	**1.889**

Key Ratios

FY-end Dec	2016	2017	2018E	2019E	2020E
Growth (%)					
Revenue	23	24	22	20	21
Gross profit	23	24	22	20	21
EBITDA	(3)	29	5	16	21
EBIT	(27)	69	10	24	32
Net profit	(1)	56	3	29	34
EPS	161	11	12	29	34
Margins (%)					
Gross	81.3	81.5	81.4	81.5	81.6
EBITDA	32.0	33.3	28.6	27.6	27.7
EBIT	12.4	17.6	15.7	16.5	18.2
Net	11.6	14.6	12.3	13.3	14.9
Others (%)					
Effective tax rate	(3)	14	14	15	15
Dividend payout ratio	-	12	13	13	26
RoCE	4	6	6	8	9
Average RoE	6	9	8	10	12
Average RoA	10	12	12	13	15
Interest cover (x)	11	15	12	20	24

Key Assumptions

FY-end Dec (YoY %)	2016	2017	2018E	2019E	2020E
KIS	12	21	10	3	2
K/3	(3)	(0)	8	2	1
EAS	16	17	18	7	4
Kingdee Cloud	90	88	40	55	40

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