

# Chinasoft (354 HK)

## Shenzhen to provide subsidies in building Harmony/ Euler ecosystem

We think Chinasoft Cloud intelligent services will maintain steady growth as 1) Shenzhen gov't will provide subsidies to software developers/ end users to cultivate Huawei's Harmony/ Euler OS ecosystem and 2) Chinasoft continues to gain share in China managed cloud service market. However, Traditional IT services segment could face slower growth as demand from internet customers softened. Maintain BUY with new target price of HK\$9.87 (prior HK\$10.52).

- Shenzhen to launch supportive measures to cultivate Harmony/ Euler ecosystem.** Shenzhen gov't released a draft for opinion ([link](#)) related to cultivating Huawei Harmony (IoT devices)/ Euler (Server) ecosystem on 30 Jun. According to the draft, Shenzhen gov't will provide subsidies to software developers/ end users to develop applications /procure devices based on Harmony/ Euler OS. We view this as positive to Chinasoft as it 1) develops kits on Harmony/ Euler OS, 2) provides embedded modules to IoT OEM.
- Cloud intelligent services: share gainer in managed cloud services market.** According to IDC, China managed cloud services market grew at +26.8% YoY in 2H21 to RMB11.8bn. Chinasoft share climbed to 3.1% in 2H21 (vs. 2.5% in 1H21). Although China cloud outlook has dampened with new Omicron variant, we are positive on new businesses related to Harmony OS/ embedded IoT modules.
- Traditional IT services: internet customers to be more conservative in IT spending.** We think IT services demand from internet customers could slow given present challenging environment. Alibaba/ Tencent accounted for ~7% of Chinasoft revenue. We think Chinasoft FY22E revenue from Alibaba/ Tencent may come down to +10% YoY (vs. >40% CAGR in the past 3 years). Also, lockdowns/ Omicron spread have added difficulty and caused delays in project implementation.
- 1H22E: Expect steady top line growth but a lower margin.** We expect Chinasoft FY1H22E revenue to grow at +15% YoY to RMB9.6bn. GPM erosion (-1.7 pts to 25.8%) will be partly offset by lower opex. Net profit is estimated to increase 5% YoY to RMB544mn. We cut FY22-24E net profit by 1-8% mainly on lower margin. Maintain BUY with new target price of HK\$9.87 (prior HK\$10.52).

### Earnings Summary

(YE 31 Dec)	FY20	FY21	FY22E	FY23E	FY24E
Revenue (RMB mn)	14,101	18,398	22,124	27,283	32,412
YoY growth (%)	17%	30%	20%	23%	19%
Net profit (RMB mn)	955	1,137	1,249	1,520	1,978
EPS (RMB)	0.32	0.36	0.40	0.48	0.63
YoY growth (%)	13%	13%	10%	22%	30%
Consensus EPS (RMB)	0.32	0.36	0.44	0.56	0.70
PE (x)	20.2	17.9	16.3	13.4	10.3
EV/Sales (x)	1.2	0.8	0.6	0.5	0.4
Dividend Yield (%)	0.00	0.00	0.00	0.00	0.00
ROE (%)	12%	11.1%	10.2%	11.3%	13.1%
Net debt to equity	Net cash	Net cash	Net cash	Net cash	Net cash

Source: Company data, Bloomberg, CMBIGM estimates

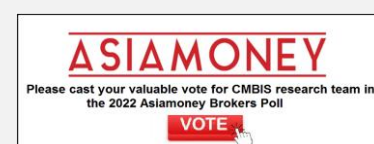
**BUY (Maintain)**

Target Price **HK\$9.87**  
 (Previous TP **HK\$10.52**)  
 Up/Downside **+33.7%**  
 Current Price **HK\$7.38**

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### Stock Data

Mkt Cap (HK\$ mn)	22,654
Avg 3 mths t/o (HK\$ mn)	92.75
52w High/Low (HK\$)	16.21/ 5.26
Total Issued Shares (mn)	3,070

Source: Bloomberg

### Shareholding Structure

Chen Yuhong- Chairman	10.8%
UBS Group AG	10.0%
ESOP	6.0%

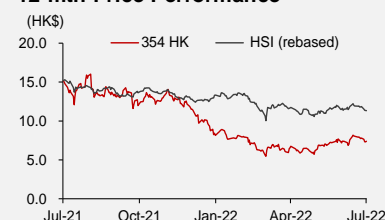
Source: HKEx

### Share Performance

	Absolute	Relative
1-mth	-0.4%	0.9%
3-mth	11.8%	14.9%
6-mth	-10.4%	5.2%

Source: Bloomberg

### 12-mth Price Performance



Source: Bloomberg

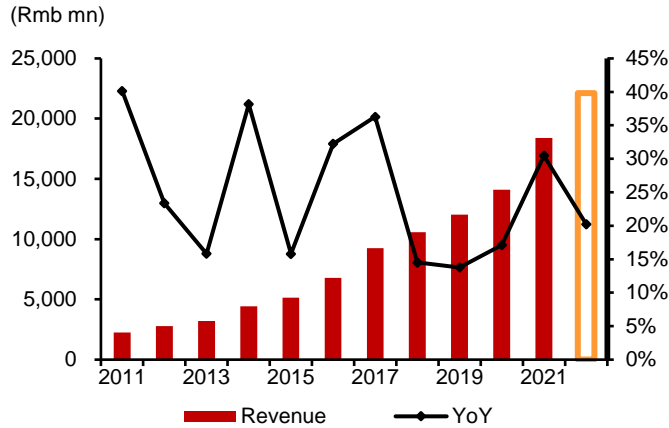
### Auditor: Deloitte

### Related Reports

- Chinasoft (354 HK) – “Strong demand despite near-term margin pressure” – 30 Mar 2022 ([link](#))
- Chinasoft (354 HK) – “Business outlook read-through from iSoftStone” – 11 Mar 2022 ([link](#))

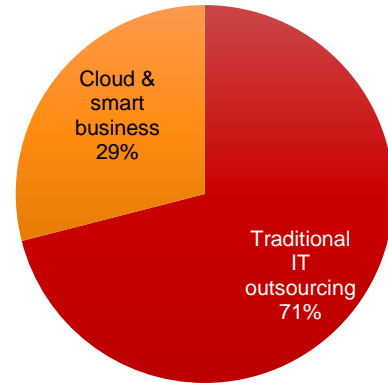
**Focus Charts**

**Figure 1: Revenue and growth**



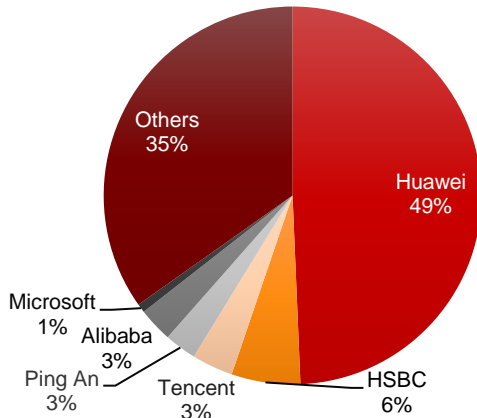
Source: Company data, CMBIGM estimates

**Figure 2: Revenue mix (2021)**



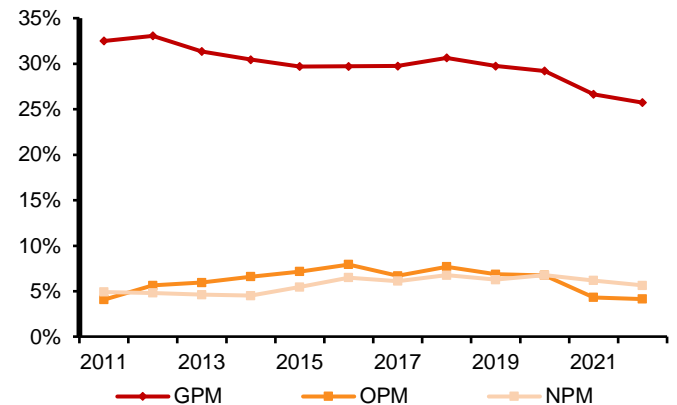
Source: Company data, CMBIGM estimates

**Figure 3: Customer breakdown (2021)**



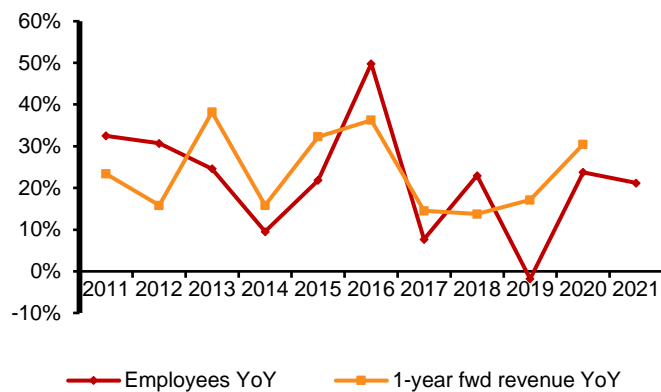
Source: Company data, CMBIGM estimates

**Figure 4: Margins**



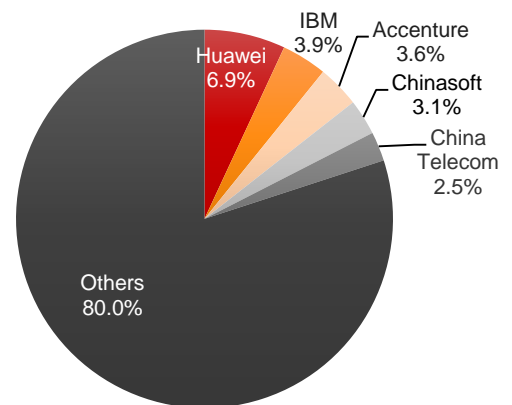
Source: Company data, CMBIGM

**Figure 5: 1-year forward revenue YoY and employees YoY**



Source: Company data, CMBIGM

**Figure 6: China managed cloud services market share (2H21)**



Source: IDC, CMBIGM

## Shenzhen to launch supportive measures in speeding up the building of Harmony ecosystem

### Event

- On 30 Jun, Industry and Information Technology Bureau of Shenzhen Municipality released “Measures to accelerate the cultivation of Harmony Euler ecosystem (draft for opinion)”. ([link](#))
- According to the draft, Shenzhen government will provide subsidies to 1) end users and 2) software developers to accelerate the adoption of HarmonyOS products. Some of the key subsidizing items are listed as below:
  - **End users**
    - Encouraging government and SOE to procure Harmony/ Euler products.
    - For projects that are nominated as “excellent demo” in the manufacturing and service industries, Shenzhen government will pay no more than RMB10mn (or 30% of total investment amount) to these enterprises.
  - **Software developers**
    - Supporting enterprises and individual developers to contribute source code to Open Harmony/ Euler communities. Top contributors can receive up to RMB1mn reward.
    - Supporting enterprise to develop and sell terminal products (e.g. server, edge computing, embedded IoT devices, cloud services etc.) based on Open Harmony/ Euler OS. Top ranked enterprises will be given a reward up to RMB2.5mn.
    - Provide R&D subsidy up to RMB500k to each of the top ranked applications developed based on Harmony OS.

### Our view

- We were concerned about the commercialization of Harmony OS as developers lack incentives to develop applications on a new OS or port applications from other OS to Harmony OS. Without popular apps, users may not want to use the devices.
- We think Shenzhen government’s new initiatives would be effective in cultivating the Harmony OS ecosystem. Developers and end users are both incentivized to use Harmony OS. In particular, government and SOEs in Shenzhen will be encouraged to procure equipment based on Harmony OS.

## Chinasoft servies surrounding Harmony OS

- **Help Huawei develop different types of kits on Harmony OS.** The development cost of each type of kits could range between RMB500k to RMB1mn. If Chinasoft develops 500 kits per year, the related IT service revenue would amount to RMB250mn.
- **Provide embedded modules for IoT OEM.** Chinasoft partners with IoT hardware suppliers to provide embedded modules to OEM such that applications can be easily deployed to Harmony OS smart devices. Chinasoft charges a fixed fee per device deployed. Assuming Chinasoft takes 10% market share of the 100mn non-Huawei smart devices on Harmony OS with each module ASP of RMB10, this will bring RMB100mn revenue opportunity to Chinasoft.
- **Co-develop IoT products with OEM.** Chinasoft can co-develop IoT products with OEM that wishes to use Harmony OS. This could be charged on project based or by fixed fee per device deployed.

## Earnings revision

Figure 7: Earnings revision

RMB mn	2022E			2023E			2024E		
	New	Old	%Diff	New	Old	%Diff	New	Old	%Diff
Sales	22,124	22,361	-1%	27,283	27,133	1%	32,412	31,341	3%
Gross profit	5,695	5,858	-3%	7,044	7,246	-3%	8,479	8,455	0%
OP Profit	918	1,066	-14%	1,215	1,484	-18%	1,621	1,868	-13%
PBT	1,347	1,362	-1%	1,655	1,798	-8%	2,151	2,253	-5%
Net profit	1,249	1,267	-1%	1,520	1,654	-8%	1,978	2,074	-5%
EPS (RMB)	0.40	0.40	-1%	0.48	0.52	-8%	0.63	0.66	-5%
<b>Margins</b>									
GM	25.7%	26.2%	-46 bps	25.8%	26.7%	-89 bps	26.2%	27.0%	-82 bps
OPM	4.1%	4.8%	-62 bps	4.5%	5.5%	-101 bps	5.0%	6.0%	-96 bps
PBT margin	6.1%	6.1%	0 bps	6.1%	6.6%	-56 bps	6.6%	7.2%	-55 bps
Net margin	5.6%	5.7%	-2 bps	5.6%	6.1%	-53 bps	6.1%	6.6%	-51 bps

Source: Company data, CMBIGM

Figure 8: CMBI estimates vs consensus

RMB mn	2022E			2023E			2024E		
	CMBI	Street	Diff	CMBI	Street	Diff	CMBI	Street	Diff
Sales	22,124	22,565	-2%	27,283	27,844	-2%	32,412	33,826	-4%
Gross profit	5,695	6,070	-6%	7,044	7,550	-7%	8,479	9,218	-8%
OP Profit	918	1,267	-28%	1,215	1,667	-27%	1,621	2,181	-26%
PBT	1,347	1,440	-6%	1,655	1,804	-8%	2,151	2,258	-5%
Net profit	1,249	1,344	-7%	1,520	1,665	-9%	1,978	2,091	-5%
EPS (RMB)	0.40	0.44	-10%	0.48	0.55	-12%	0.63	0.67	-7%
<b>Margins</b>									
GM	25.7%	26.9%	-116 bps	25.8%	27.1%	-130 bps	26.2%	27.3%	-109 bps
OPM	4.1%	5.6%	-147 bps	4.5%	6.0%	-153 bps	5.0%	6.4%	-145 bps
PBT margin	6.1%	6.4%	-29 bps	6.1%	6.5%	-41 bps	6.6%	6.7%	-4 bps
Net margin	5.6%	6.0%	-31 bps	5.6%	6.0%	-41 bps	6.1%	6.2%	-8 bps

Source: Company data, CMBIGM

**Figure 9: Operating model**

RMB mn	2020	2021	2022E	2023E	2024E
Revenues	14,101	18,398	22,124	27,283	32,412
Cost of sales	(9,983)	(13,494)	(16,428)	(20,238)	(23,933)
Gross Profit	4,118	4,904	5,695	7,044	8,479
<i>Gross margin</i>	<i>29.2%</i>	<i>26.7%</i>	<i>25.7%</i>	<i>25.8%</i>	<i>26.2%</i>
R&D	(930)	(1,249)	(1,553)	(1,853)	(2,226)
SG&A	(2,031)	(2,699)	(2,945)	(3,688)	(4,359)
Operating Income	952	796	918	1,215	1,621
<i>Operating margin</i>	<i>6.7%</i>	<i>4.3%</i>	<i>4.1%</i>	<i>4.5%</i>	<i>5.0%</i>
Non-Operating Income	83	456	429	440	530
Profit Before Tax	1,035	1,252	1,347	1,655	2,151
Income tax (expense) gain	(87)	(115)	(102)	(137)	(177)
Minorities	(7)	(0)	(4)	(3)	(4)
Net Income to Shareholders	955	1,137	1,249	1,520	1,978
<i>Net margin</i>	<i>6.8%</i>	<i>6.2%</i>	<i>5.6%</i>	<i>5.6%</i>	<i>6.1%</i>
EPS (RMB)	0.33	0.37	0.40	0.48	0.63
Fully diluted EPS (RMB)	0.32	0.36	0.40	0.48	0.63
<b>Revenue breakdown</b>					
IT outsourcing	10,830	13,063	14,761	16,975	19,012
Emerging cloud business	3,271	5,335	7,363	10,308	13,400
Huawei	8,030	9,880	11,362	12,839	14,508
HSBC	830	1,180	1,180	1,180	1,180
Tencent	500	706	741	890	1,067
Alibaba	400	590	620	805	1,047
Ping An	450	550	660	792	950
Others	3,891	5,492	7,561	10,777	13,659
<b>Growth YoY</b>					
Revenues	17%	30%	20%	23%	19%
Gross profit	15%	19%	16%	24%	20%
Operating Income	15%	-16%	15%	32%	33%
EPS	7%	13%	7%	22%	30%

Source: Company data, CMBIGM estimates

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

RMB mn	1H20	2H20	1H21	2H21	1H22E	2H22E
Revenues	6,059	8,042	8,341	10,057	9,624	12,500
Gross Profit	1,649	2,469	2,294	2,610	2,483	3,212
Operating profit	421	531	423	374	443	475
Net profit (loss)	401	554	518	619	544	705
EPS (RMB)	0.16	0.19	0.19	0.20	0.18	0.22
<b>Margins</b>						
Gross margin	27.2%	30.7%	27.5%	26.0%	25.8%	25.7%
Operating margin	6.9%	6.6%	5.1%	3.7%	4.6%	3.8%
Net margin	6.6%	6.9%	6.2%	6.2%	5.7%	5.6%
<b>Growth (HoH)</b>						
Revenues	-7%	33%	4%	21%	-4%	30%
Gross Profit	-18%	50%	-7%	14%	-5%	29%
Operating profit	5%	26%	-20%	-12%	18%	7%
Net profit (loss)	2%	38%	-6%	20%	-12%	30%
<b>Growth (YoY)</b>						
Revenues	9%	24%	38%	25%	15%	24%
Gross Profit	5%	22%	39%	6%	8%	23%
Operating profit	-1%	32%	0%	-30%	5%	27%
Net profit (loss)	11%	41%	29%	12%	5%	14%

Source: Company data, CMBIGM estimates

## Valuation

### Chinasoft (354 HK, BUY, TP HK\$9.87)

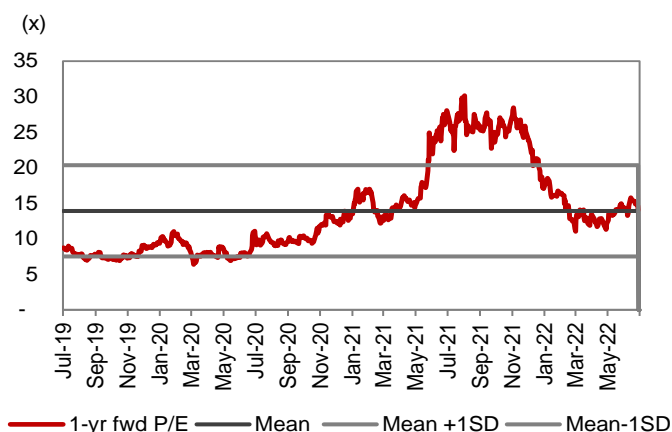
We cut FY22-23E net profit by 1-8% mainly to reflect lower margins. Maintain BUY with lowered target price of HK\$9.87 (prior HK\$10.52), based on 18x FY23E fully diluted EPS. Our target multiple implies 30% premium to past three years mean as margin improvement in FY23-24E should drive re-rating.

Figure 11: Peers' valuation

Company	Ticker	Rating	Mk Cap (US\$ mn)	Price (LC)	TP (LC)	P/E FY22E	P/E FY23E	ROE FY22E	ROE FY23E	Sales CAGR FY21-24E	EPS CAGR FY21-24E
Chinasoft	354 HK	BUY	BUY	2,894	9.87	16.3	13.4	10.2	11.3	21%	15%
iSoftStone	301236 CH	NR	NR	3,314	35.10	N/A	n.a.	n.a.	n.a.	n.a.	n.a.
Digital China	000034 CH	NR	NR	1,491	15.18	N/A	n.a.	n.a.	n.a.	n.a.	n.a.
Infosys	INFO IN	NR	NR	76,231	1444.45	N/A	27.1	24.2	30.1	31%	9%
Tata Consultancy	TCS IN	NR	NR	139,462	3038.75	N/A	29.1	26.4	41.2	44%	8%
					<b>Mean</b>	<b>27.3</b>	<b>22.8</b>	<b>23.4</b>	<b>25.3</b>	<b>15%</b>	<b>20%</b>
					<b>Median</b>	<b>27.6</b>	<b>23.1</b>	<b>21.6</b>	<b>23.2</b>	<b>13%</b>	<b>21%</b>

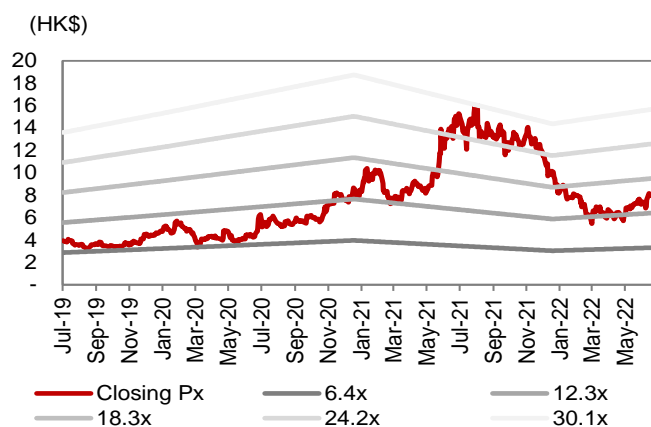
Source: Bloomberg, CMBIGM

Figure 12: 12M forward P/E band



Source: Company data, CMBIGM

Figure 13: 12M forward P/B band



Source: Company data, CMBIGM

## Financial Summary

### Income statement

YE 31 Dec (RMB mn)	FY20A	FY21A	FY22E	FY23E	FY24E
<b>Revenue</b>	<b>14,101</b>	<b>18,398</b>	<b>22,124</b>	<b>27,283</b>	<b>32,412</b>
Cost of sales	(9,983)	(13,494)	(16,428)	(20,238)	(23,933)
<b>Gross profit</b>	<b>4,118</b>	<b>4,904</b>	<b>5,695</b>	<b>7,044</b>	<b>8,479</b>
Selling exp	(729)	(943)	(1,083)	(1,336)	(1,587)
Admin exp	(1,302)	(1,756)	(1,862)	(2,353)	(2,772)
R&D exp	(930)	(1,249)	(1,553)	(1,853)	(2,226)
Other operating exp.	(205)	(159)	(280)	(289)	(273)
<b>Operating profit</b>	<b>952</b>	<b>796</b>	<b>918</b>	<b>1,215</b>	<b>1,621</b>
Finance costs	(151)	(100)	(87)	(84)	(94)
Other non-oper exp.	235	555	517	523	624
<b>Pre-tax profit</b>	<b>1,035</b>	<b>1,252</b>	<b>1,347</b>	<b>1,655</b>	<b>2,151</b>
Income tax expense	(87)	(115)	(102)	(137)	(177)
Minority interests	(7)	(0)	(4)	(3)	(4)
<b>Net profit to shareholders</b>	<b>955</b>	<b>1,137</b>	<b>1,249</b>	<b>1,520</b>	<b>1,978</b>

### Cash flow summary

YE 31 Dec (RMB mn)	FY20A	FY21A	FY22E	FY23E	FY24E
<b>Net profit</b>	<b>1,035</b>	<b>1,252</b>	<b>1,347</b>	<b>1,655</b>	<b>2,151</b>
Depreciation/amortization	170	221	118	112	116
Change in working capital	(533)	(887)	667	(782)	(989)
Others	480	376	(102)	(137)	(177)
<b>Net cash from operating</b>	<b>1,153</b>	<b>962</b>	<b>2,030</b>	<b>847</b>	<b>1,101</b>
Capex	(159)	(287)	(150)	(150)	(150)
Others	(32)	(242)	(43)	(42)	(40)
<b>Net cash from investing</b>	<b>(192)</b>	<b>(530)</b>	<b>(193)</b>	<b>(192)</b>	<b>(190)</b>
Net borrowings	217	173	(27)	232	290
Dividend paid	-	-	(94)	(114)	(147)
Others	145	1,204	4	3	4
<b>Net cash from financing</b>	<b>362</b>	<b>1,377</b>	<b>(117)</b>	<b>121</b>	<b>147</b>
<b>Net change in cash</b>	<b>1,323</b>	<b>1,810</b>	<b>1,720</b>	<b>777</b>	<b>1,058</b>
Cash at beginning of the year	2,526	3,787	5,556	7,591	8,409
Exchange difference	(62)	(40)	315	42	40
<b>Cash at the end of the year</b>	<b>3,787</b>	<b>5,556</b>	<b>7,591</b>	<b>8,409</b>	<b>9,507</b>

### Balance sheet

YE 31 Dec (RMB mn)	FY20A	FY21A	FY22E	FY23E	FY24E
<b>Current assets</b>	<b>10,394</b>	<b>13,520</b>	<b>14,868</b>	<b>17,046</b>	<b>19,835</b>
Cash & equivalents	3,787	5,556	7,591	8,409	9,507
Account receivables	4,580	5,894	5,323	6,345	7,626
Amount due from customers	1,904	1,741	1,585	1,885	2,249
Other current assets	123	328	368	407	453
<b>Non-current assets</b>	<b>2,693</b>	<b>3,383</b>	<b>3,143</b>	<b>3,181</b>	<b>3,215</b>
PPE	858	1,220	1,024	1,104	1,178
Intangible assets	1,086	1,037	993	951	911
Other non-current assets	749	1,126	1,126	1,126	1,126
<b>Total assets</b>	<b>13,087</b>	<b>16,902</b>	<b>18,011</b>	<b>20,227</b>	<b>23,050</b>
<b>Current liabilities</b>	<b>2,718</b>	<b>3,986</b>	<b>4,060</b>	<b>4,761</b>	<b>5,617</b>
ST borrowings	368	917	1,012	1,135	1,288
Account payables	1,753	2,252	2,770	3,293	3,928
Accrued expense	117	181	0	0	0
Other current liabilities	480	635	279	333	400
<b>Non-current liabilities</b>	<b>1,592</b>	<b>1,290</b>	<b>1,169</b>	<b>1,279</b>	<b>1,415</b>
LT borrowings	1,421	1,021	900	1,009	1,146
Other non-current liabilities	171	269	269	269	269
<b>Total liabilities</b>	<b>4,311</b>	<b>5,276</b>	<b>5,229</b>	<b>6,039</b>	<b>7,032</b>
Share capital	132	139	139	139	139
Capital surplus	4,735	6,294	6,294	6,294	6,294
Retained earnings	4,492	5,760	6,916	8,322	10,152
Other reserves	-605	-589	-589	-589	-589
Minority interest	23	23	23	23	23
<b>Total equity</b>	<b>8,776</b>	<b>11,627</b>	<b>12,782</b>	<b>14,188</b>	<b>16,019</b>
<b>Total liabilities and equity</b>	<b>13,087</b>	<b>16,902</b>	<b>18,011</b>	<b>20,227</b>	<b>23,050</b>

### Key ratios

YE 31 Dec	FY20A	FY21A	FY22E	FY23E	FY24E
<b>Revenue mix</b>					
Emerging cloud business	17%	23%	29%	33%	38%
Traditional IT outsourcing	83%	77%	71%	67%	62%
<b>Growth (%)</b>					
Revenue	17%	30%	20%	23%	19%
Gross profit	15%	19%	16%	24%	20%
Operating profit	15%	-16%	15%	32%	33%
Net profit	26%	19%	10%	22%	30%
<b>Profit &amp; loss ratio (%)</b>					
Gross margin	29.2%	26.7%	25.7%	25.8%	26.2%
Operating margin	6.7%	4.3%	4.1%	4.5%	5.0%
Net profit margin	6.8%	6.2%	5.6%	5.6%	6.1%
<b>Balance sheet ratio</b>					
Receivable turnover days	117	115	87	84	85
Amount due days	49	34	26	25	25
Payable turnover days	63	60	61	59	59
Current ratio (x)	3.82	3.39	3.66	3.58	3.53
Net debt to equity	net cash	net cash	net cash	net cash	net cash
<b>Profitability (%)</b>					
ROE	12.5%	11.1%	10.2%	11.3%	13.1%
ROIC	13.5%	10.1%	11.8%	15.6%	18.4%
<b>Per share data (RMB)</b>					
EPS (RMB)	0.32	0.36	0.40	0.48	0.63
DPS (RMB)	0.03	0.03	0.03	0.04	0.05
BVPS (RMB)	2.93	3.68	4.05	4.49	5.07

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