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to new businesses like cloud

Disclosures & Disclaimer

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Investment summary

Chinasoft set to further cement its leading position as premier IT service provider with robust growth

hile pushing into cloud-oriented new businesses that we see accounting for almost a quarter of revenue by FY21

Valuation hit by Huawei concerns, but we see it recovering given growth outlook and potential improvement in earnings quality

A long-time leader in China IT services industry

Founded in the year 2000, Chinasoft International (CSI) has nearly two decades of experience as a reliable and leading IT services provider for companies in China, particularly those in the finance and technology industries. Its major products and services include software and application development, IT consulting and training, business process outsourcing and data analysis. In recent years, it has also started migrating its services to cloud-based platforms and capturing the business opportunities from the broad trend towards cloud-based services. The IT services industry in China has been growing at low-to-high teens over the last decade, equivalent to around 1.5 2x GDP growth, reflecting the strong demand from corporates for digital upgrades in China over the last decade.

Emerging products and services include its JointForce platform (which connects software engineers and clients using cloud-oriented crowdsourcing), Cloud as a Solution (including cloud-based software development and cloud management services) and managing Big Data. From FY08 to FY18, the company generated revenue growth at a CAGR of 26.8%. The result is it has become the most critical IT services provider to a number of large e-commerce names like Alibaba, Tencent and Huawei. CSI is equipped with strong R&D to help develop cloud-based applications and platforms. Its sales and marketing forces are also helping the company rapidly develop its self-branded new businesses like JointForce and Big Data, providing Chinasoft with a competitive advantage rarely found among traditional IT services companies. From FY18 to FY21e, we forecast a 15.7% CAGR and reported net profit at a 15.5% CAGR.

Looking beyond Huawei: New businesses as next growth engine

While Huawei is an important customer, we see new business segments as the next drivers of growth

As a flagship name in the industry, CSI is now the largest IT services provider to Huawei, the telecom giant caught in the crosshairs of Sino-US trade tension (see *China and the US restart trade talks*, 29 Jun 2019). last year, using a broad range of services from CSI for its R&D of different business segment ranging from chipsets to cloud services. This relationship with such a significant tech player has meant CSI has improved its service quality and acquired many transferrable skills in product development and customer relationship management.

Given the close co-operation, the market has generally viewed CSI as an investment proxy to though suggests that it is the emerging business segments largely do not involve that will drive sustainable growth for the next two to three years. According to CSI, emerging businesses are classified into three categories:

JointForce: This platform allows clients like SMEs and local governments to connect up directly with software engineers by using cloud-based crowdsourcing. Product delivery could be on cloud or on-premises.

Cloud Services: As a non-conventional cloud services provider, CSI does not specifically target one layer of cloud-based product structure. Instead, it has launched its cloud business with a business model to provide customised services and products to large enterprises and governments.

Big Data: This segment helps corporates with data collection, management and analytics.

We identify three factors that lead us to take businesses. Firstly, CSI has been dedicated in building up a cloud-based ecosystem for years, which has equipped the company with capabilities to satisfy a wide array of demands from across different industries. Secondly, CSI has built up strong expertise in understanding the complexity of different IT platforms. Thirdly its broad customer base provides a solid foundation for monetisation of emerging businesses. In FY18, its emerging businesses collectively grew by 73% YoY and accounted for 15% of total revenue. The absolute growth amount in FY18 was equivalent to 50% of total revenue growth.

Undervalued with catalysts in both the near and medium term

Research & Development demands from Chinese tech giants are unlikely to dry up even if the trade tension further escalates

share price has dropped by 27% from its YTD high, mostly due to worries that the restrictions imposed by the US administration on Huawei will impact CSI given the telecom giant is responsible for just over half of its revenues. The result is the stock is trading at 11.5x FY19e earnings, near the lowest level in a decade. However, we believe the stock is largely undervalued. While there is a level of customer concentration risk in relation to Huawei, the market may not understand that CSI unlikely to dry up even in a worst case trade tension situation. The previous restrictions from the US spurred Chinese technology companies to accelerate domestic R&D and domestic production of key components and software systems, a recipe for creating long-term business opportunities for CSI. Furthermore we have seen that the telecom, cloud and chipset businesses of Huawei areas which are the drivers of services for CSI have been less impacted by the US restrictions all, especially following President Trump he would allow US companies to sell components to Huawei again (according to a report on Bloomberg).

As a further headwind, emerging businesses that are mostly independent from Huawei have become the real growth drivers for CSI and paving the path to the cloud-based IT world for the company. As a result, w ow at a CAGR of 15.7% from FY18-21e. We expect growth of emerging businesses to outpace the overall rate of revenue growth (35% YoY for the same period). And by the end of FY21e, we expect emerging businesses to account for 24% of total revenue.

-term growth outlook, reflecting our above-consensus FY21 forecasts. In the following sections, we conduct a market sizing exercise to assess the opportunities of developing a domestic operation system, a sensitivity analysis on a Solution business. The near-term catalyst in our view is C interim results, and medium-term catalysts include potential organisation changes that could strengthen its cloud segment.

Valuation, rating and risks

Move into higher-margin new businesses to help CSI extend its growth momentum

CSI is trading at

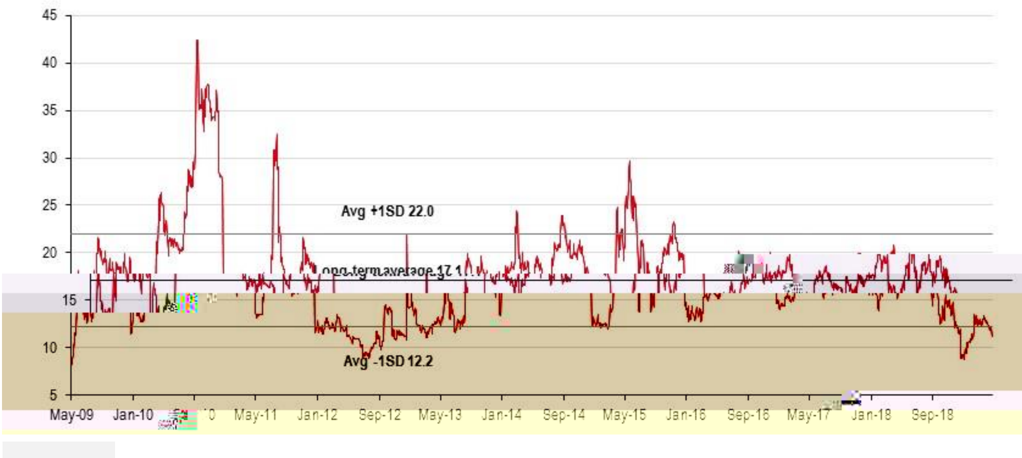
Valuation

We use a PE-based valuation methodology to value CSI as we believe its earnings, and earnings growth, are critical indicators for the expansion into new businesses should also be reflected in its earnings. Over the last ten years, the average one-year forward PE (non-GAAP earnings) is 17.1x with a standard deviation of 4.9.

We assign a target multiple of 14.7x FY19e non-GAAP earnings for our valuation, 0.5 standard deviation below its historical average (over the last 10 years). The discount stems mostly from our expectation of slower bottom-line growth (compared with its long-term average) and disruption of the business operations . It returns a target price of HKD5.59 per share. CSI delivered 28% CAGR growth in EPS from FY15-18 when the stock was trading at between 17x and 20x PE for the most of the time. We forecast EPS to grow at 10% CAGR from FY19-21e. The slowdown we are forecasting is mainly due to share dilution, higher SG&A to develop new businesses and a larger base. Despite the slowdown in absolute earnings growth, we believe the growth and earnings quality will be essentially better than in FY15-18. ing to better growth sustainability as well improving its corporate image.

Our target price implies 37% upside from the closing price on 4 July 2019. Thus, we have a Buy rating on this stock.

Exhibit 1: CSI 10-year PE trading trend



CSI is trading at a discount to its peers

Exhibit 2: CSI comparative valuations table

Unexpected policy changes: CSI is in a favourable position to directly and indirectly benefit from the development of the cloud computing industry in China, particularly the SOE and local government segment. Any unexpected and unfavourable changes to the policy support for the cloud computing industry in China would lead to slower-than-expected growth.

Slower-than-expected new business rollout: This would slow down process and delay the potential re-rating opportunities.

Sharp RMB appreciation: This would hurt CSI s and lead to potential revenue decline in overseas markets.

Where are we different from consensus?

Exhibit 3: HSBC vs consensus

Growth trajectory of emerging businesses to follow the -

From FY18-21, consensus forecasts the revenue growth pace to be roughly steady, at a low to mid-teens level. We see revenue growth slowing down to a certain extent in 2020 given uncertainty , and emerging businesses will still be in the development stage. From FY21, though, we expect CSI to harvest its efforts from new business initiatives, particularly those related to the cloud. We think the J-curve trend will also be reflected in changes to margins from FY19-21e.

Looking into Huawei impact

While Huawei remains a key customer, and is responsible for over

a modest slowdown for CSI in the short term due to US/Huawei issues and stay constructive over the long term

and using modest assumptions we believe operating system could create a new RMB4.7bn market for CSI

Huawei is a key player for CSI

Huawei has become an important customer for CSI, contributing c53% of total revenue last year, following the establishment of a JV in 2012 between the two to improve the quality of service delivery and consolidate their cooperation.

However, from the perspective of business strategy, this has led to significant customer concentration risk, especially in light of the recent US restrictions, and which is reflected in the discount we apply to our target multiple we use to value the stock. Over the past several years, spending has been increasing at a double-digit rate &D expenses by the end of 2018, with CSI mostly es.

Exhibit 4: Huawei R&D expense trend (RMBbn)

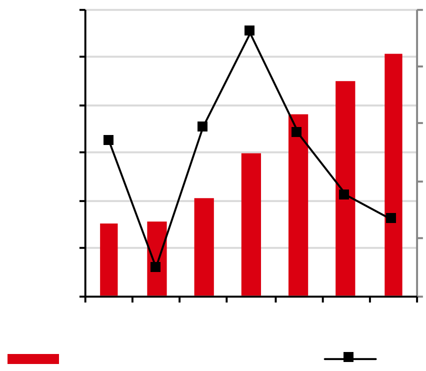
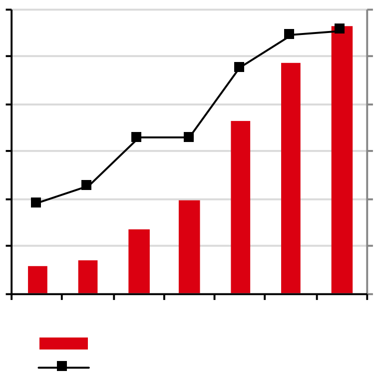


Exhibit 5 as a % of



More Huawei restrictions could create short-term disruption to CSI

During a brief period (2Q19) when the Trump administration fully restricted Huawei from sourcing services and components from US-based supplies, we observed some disruption to with Huawei. Importantly though, this was simply reallocation of resources among different business lines, rather than scaling back its R&D activities. However given the high degree of concern, we conduct a sensitivity analysis to look into downside risk if the US government was to re-impose restrict .

Exhibit 6 exposure to Huawei (FY19)

Our base-case revenue forecast from Huawei is 12% YoY growth for FY19e, suggesting a moderate slowdown from last year (15% YoY for FY18). The slowdown is mainly as a result of the short-term disruption from the restrictions imposed by the US government with CSI needing to adjust its resource allocation to different business lines of Huawei. Our analysis suggests that even if revenue from Huawei declined by 12% YoY this year, CSI could still maintain low-single-digit revenue growth.

We see long-term opportunities from the trend of localisation

China has been increasing its efforts to enhance domestic innovation capabilities in high-value

initiatives to localise the development and production of key equipment and electronic components. The recent restrictions on Huawei are likely to further propel Chinese technology companies to develop their own hardware and software, with Huawei founder Ren Zhengfei S then he is confident he can use components made in China and other countries (Financial Times, 2 July 2019).

We conduct a market sizing analysis on potential revenue opportunities from Huawei developing its own operating system. The total revenue generated from IOS and Android was estimated to be cRMB740bn for 2018 according to Sensor Tower, a third party data vendor. The average take rate from a system developer is around 30%. Our calculation suggests that the addressable market for CSI could be RMB4.7bn (vs FY18 total revenue of RMB10.6bn) in 2021 given the following assumptions:

- The growth rate of the market is in line with previous years: 12% CAGR
- Average take rate from system developers is 30%
- 15% of total revenue to be paid to IT service providers as an operating expense item for application development and system maintenance

Exhibit 7: Market sizing analysis of potential Huawei OS market for CSI

The traditional leader embraces transformation

While CSI is the leader in traditional IT services, the company is accelerating its push into new businesses

Over the last two decades, CSI has focused on the right market segments and has grown impressively as a result

Cloud, Big data and JointForce will help CSI open up the new chapter of cloud computing

Company overview

Chinasoft International (CSI) is a leading ICT and digitalisation solution provider in China. It primarily engages in IT services, software design & delivery, cloud services and big data solutions. The company has established dominant positions within different vertical groups such as telecom, finance, government, manufacturing, Internet, energy industries and so on over the last two decades. Apart from its home market, CSI has also expanded its footprint to overseas markets including Hong Kong, the US, Japan and Malaysia.

Business segments

T al structure is such that there are two major segments: TPG (Technical & Professional Services Group) and IIG (Internet IT Services Group).

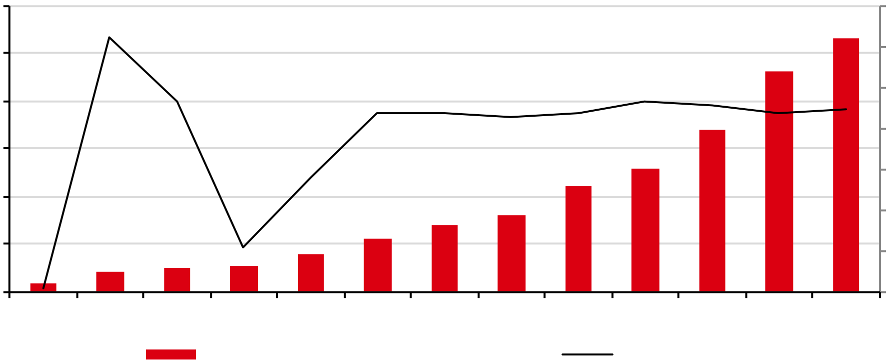
TPG Huawei, HSBC, Tencent, Alibaba, China Mobile and other large corporates across different industries.

IIG is established around the JointForce platform
platform that aims to capture under-serviced IT accounts and the government market in China. By the end of FY18, the revenue from TPG accounted for 86.7% of total revenue and the remaining 13.3% belonged to IIG.

Exhibit 8: CSI revenue breakdown by segment (RMBm)

However, Chinasoft International (CSI) has managed to scale up and offer long-term investment value. Chinasoft was founded in 2000 and listed in Hong Kong in 2003. The IT specialist has survived several economic downturns at home and globally. The company managed to grow its annual revenue from below the RMB1bn level a decade ago to over RMB10bn in 2018. Except for a brief period during the Global Financial Crisis, the company has maintained its PBT margin at high-single-digit levels, a feat that only very few TMT China companies have accomplished over the last two decades. As s, it has become the flagship name for the IT services sector in China.

Exhibit 10: CSI revenue and margin trends



By working with major customers, CSI is always close to edge-cutting technologies

by working closely with leading companies in different vertical groups. CSI built up strong relationships with and derived the majority of its revenue from

Stick with the right wallets
Working with leading companies from different verticals is only successful if the right industries and major customers are chosen, and they all grow
almost every vertical group represents a promising growth outlook on paper. However, for a medium-sized TMT company, ensuring stable growth and visibility is often more important than the absolute potential market size.

For CSI, we believe it is strategically right for it to stick with three vertical groups: technology, finance and government. In terms of IT spending, these three groups may not be the biggest contributors but they have three qualities that make them safe and attractive market segments:

1. **They are always the beneficiaries of key policies promoting the development of TMT industry in China.** Local governments and SOE financial institutions are the executors of national policies and largest spenders at the same time.
2. **Their IT spending demonstrates strong defensiveness, even through economic down-cycles.** While finance and technology industries are seen as typically more vulnerable to economic crisis, the reality is that it is rare for them to slash IT spending given their scale of operations. In fact, technology companies normally keep up a high level of R&D spending during down-cycles in order to achieve future breakthroughs. For government bodies, their role of stimulating spending on TMT is usually amplified during economic downturns, benefitting CSI and giving it a defensive quality.
3. **They are normally rich in cash leading to less pressure in working capital management.** Cash collection is always an issue when medium-sized companies transact with larger-sized customers
payments have helped CSI alleviate the pressure of working capital management and reduce some potential borrowing and unnecessary finance costs.

Proper level of diversification
Working together with leaders from different vertical groups enables CSI to deliver encouraging growth. The right level of customer diversification, on the other side, hedges the downside risk of top-line growth, implying that the positive impact may not be quite as obvious as it may initially appear.

Challenges that have propelled

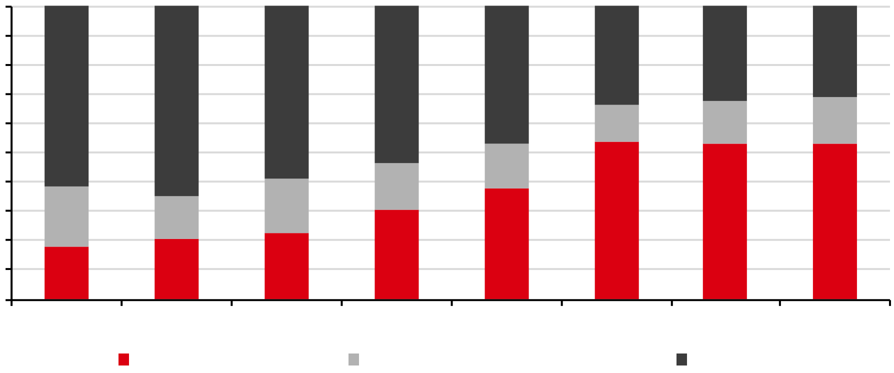
Success over the last decade may not always mean a promising outlook for the future
Challenges surrounding CSI are a constant, helping the company make bigger strides into transitioning itself into a corporate-centric Digtialisation 2.0 company and promote its self-branded products and to upgrade its corporate profile.

We see two key challenges that may threaten -term growth outlook:

Highly concentrated in relation to Huawei:

overall revenue has risen rapidly from 18% as at Dec 2011 to 53% as at Dec 2018, and we forecast the ratio will stay at this high level going forward. From the perspective of business operations, it presents a high degree of customer concentration risk, particularly considering the different level of bargaining power of these two sides. Investors are also concerned by it, with the recent de-rating of mostly stemming from worries about the negative impact on s between China and the US. However as we have explained above ei is little affected and we expect CSI to continue to monetise

Exhibit 12: CSI revenue distribution among Huawei and other customers



Traditional IT outsourcing growth is slowing down: The slowdown in the labour-intensive IT outsourcing service industry is inevitable in our view. First, overall IT and software industry profit growth is slowing down after a period of solid and rapid growth in the domestic market. Second, customers in this industry are facing pressures to save on costs. Decades ago, outsourcing proved to be an effective measure but now customers are gradually scaling back from outsourcing service providers to further save IT costs. Moreover, IT services is also slowing down, removing a key growth engine.

Exhibit 13: China software industry profit

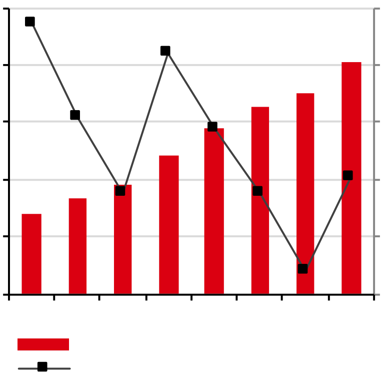
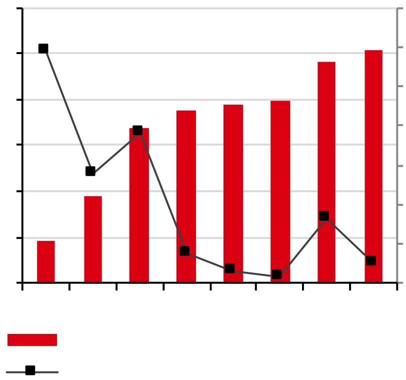
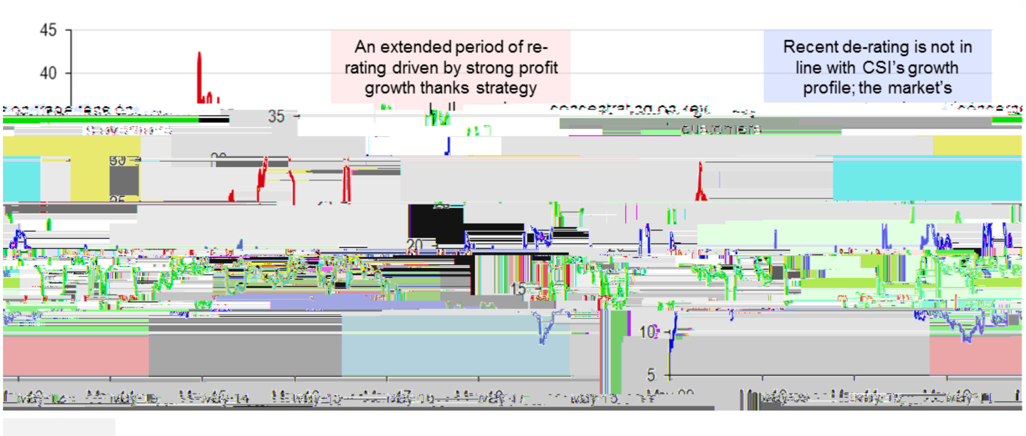


Exhibit 14: China software services and product exports



Capital markets seem to be very cautious about concentration risk in relation to Huawei and the legacy nature of software outsourcing businesses. The stock has rarely traded above 20x 12m forward earnings in recent years. CSI was also in the frontline of the recent equity selloff due to trade tensions between China and the US.

Exhibit 15: Chinasoft International (CSI) 12-month forward PE multiple



Transforming into the future

Under the tougher operating environment, CSI kicked off its transformation, aiming to become a key ICT solution provider, a facilitator of corporate IT infrastructure upgrades and further consolidate its role as a vital IT partner for existing customers. Similar to most companies who proactively seek transformation, its financial objective is simple: more sustainable revenue growth, higher margins and a stronger cash-flow profile. From 2016, CSI mainly focussed on two directions to realise this vision:

- **Self-branded products and services** to enhance its corporate image and gradually build centrepiece in the making. The company has also launched its own SaaS products.
- **Expansion into emerging areas together with leaders from different vertical groups**.

-transformation

JointForce (JF): an innovative ecosystem as a solution to the tough long-tail IT market
JF is an online-based IT services crowdsourcing platform. It was designed to enable communication and transactions

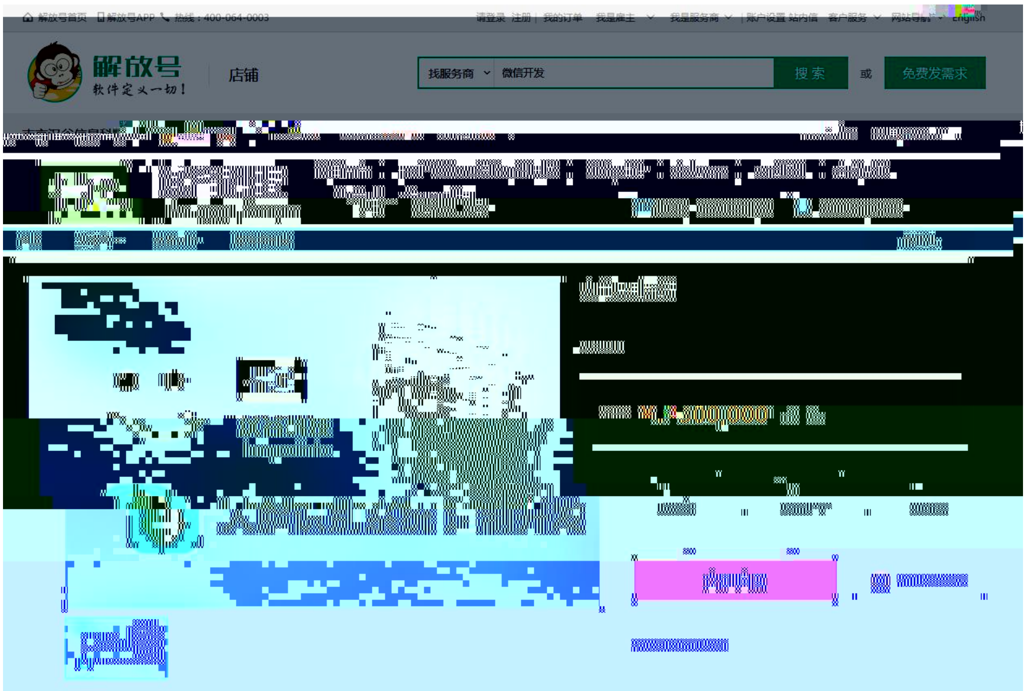
There are three monetisation channels for the JF platform:

Membership fee: All registered software engineers on the platform can opt for fee-paying platform membership. Fee-paying members enjoy certain premium services, which will essentially translate into more job matching and revenue for fee-paying members.

Commission from job matching: This works in a similar way to some e-commerce and Internet platforms. The JF platform charges certain percentages of GMV (gross merchandise value) as commission.

IT services performed by CSI itself: CSI is still an important force for the supply side of the -house team takes jobs and generates revenue. In this way, the JF platform serves as a distribution channel for CSI although that was not the

Exhibit 19



society as a whole. The most valuable part of the platform is the unique ecosystem being built up specifically for the SME long-tail markets, which are currently underserved by mainstream providers. We believe this has the

It could improve operational efficiency and consolidate the long-tail IT services market in a meaningful way

A robust and healthy ecosystem could set up high entry barriers for new entrants and further differentiate JF from other platforms

JF platform could enable CSI to be technology neutral and be flexible with its product and services

Cloud business to stay in line with the migration trend in corporate IT infrastructure

is the cloud business. Apart from some SaaS applications launched by CSI, it mainly engages in cloud consulting and implementation services. As discussed in a previous section of this report, a large number of corporates are still unclear about how to build up their cloud-based IT infrastructure and are not fully migrating to a cloud-

Efforts to build up a stronger brand image still needed

Brand image and self-branded products are of greater importance while CSI transforms itself from a traditional IT services company to a one-stop digital solutions provider. CSI has a comprehensive portfolio of products and services. It needs to better address the ways in which it brands and markets different offerings to relevant customer groups, in our view.

Exhibit 22: CSI SWOT analysis

Broadening China IT services

Growth of spending on IT services continues to outpace other categories of tech spending, but it is slowing down

The IT services market will likely remain fragmented in China

Migration to a cloud-based IT infrastructure is creating opportunities for cloud implementation and solutions-oriented businesses

Traditional IT services industry in China

The traditional IT services industry has moved into a very mature stage globally. The global market size has grown to around USD1trn in recent years, according to Gartner, a third party vendor, with the YoY growth rate slightly higher than the global GDP growth rate. US companies with strong consulting capabilities are leading the league table due to more high-value added services in their revenue mix. Indian IT service companies have further consolidated their positions in global markets, particularly in the banking and finance sectors.

Exhibit 23: Global IT spending forecast by category (USDbn)

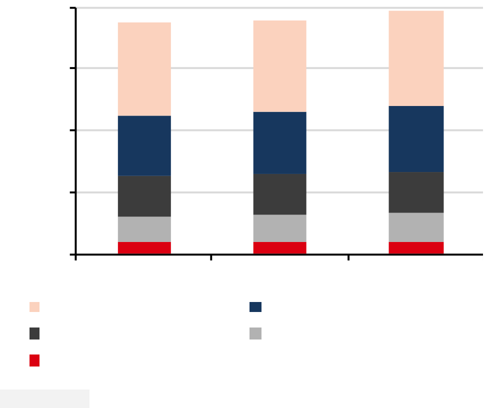
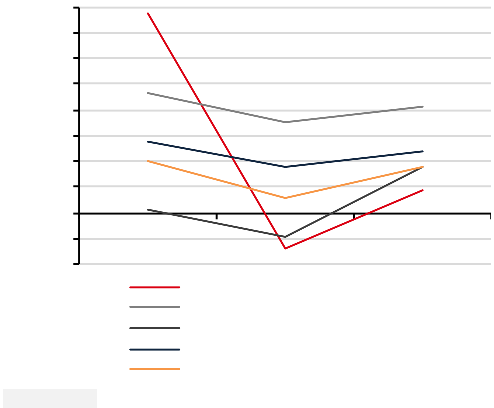


Exhibit 24: Global IT spending change YoY by category



Due to rapid digitalisation in China, domestic IT services companies have shifted more of their has slowed down to low single digits in recent years. The market is fragmented as even though CSI is the largest IT services provider in China, it only has c4% of domestic market share. The overall growth rate (tech consulting and outsourcing services combined) is between 12% and 18% YoY in recent years. The macro-economy is the single largest factor as most vertical groups adjust their IT spending budget in line with overall economic conditions.

Exhibit 27: China Digitalisation 2.0

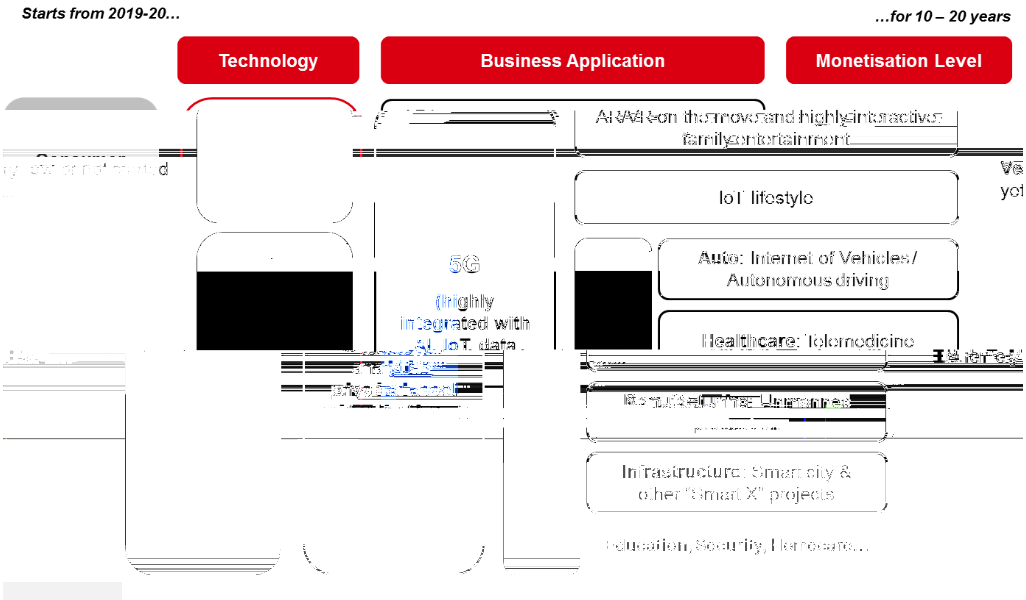
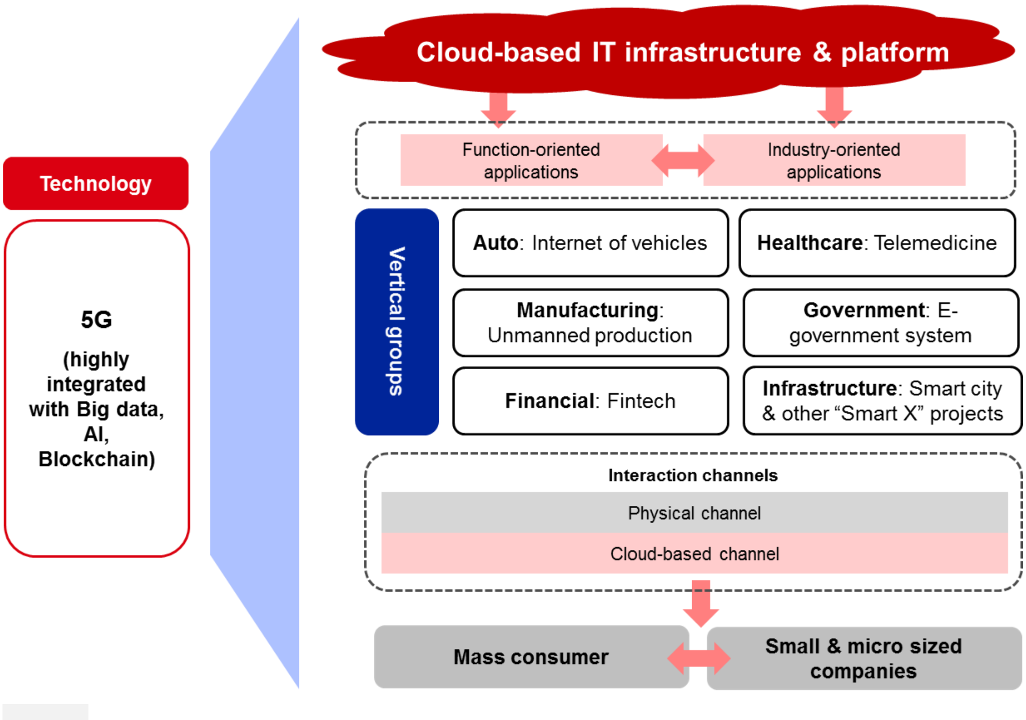


Exhibit 28: Cloud-based IT infrastructure in Digitalisation 2.0



There are two areas we identify that are particularly important and related to CSI: Cloud implementation & consultancy services, and solutions as a service.

Cloud services and implementation

China is in fact lagging behind major developed countries in terms of cloud services. According to CAICT, a research arm under MIIT, over 45% of Chinese enterprises do not have plans for introducing cloud computing applications to their existing IT infrastructure at this moment. This presents attractive

Key assumptions and forecasts

grow at 15.7% CAGR from FY18-21e thanks to strong momentum of new businesses

We forecast OPM and GPM to continue to expand given higher margins generated by new business

Working capital management is crucial to maintaining healthy cash growth

New businesses will be key growth drivers

For FY18-21e, we forecast revenue to grow at 15.7% CAGR, lower than historical We forecast new businesses (JF Platform, Big Data and Cloud business) to grow at 35.1% for the same period. By the end of FY21e, new businesses will account for 24% of total revenue (15% by the end of FY18).

Exhibit 30: CSI revenue growth trend (RMBm)

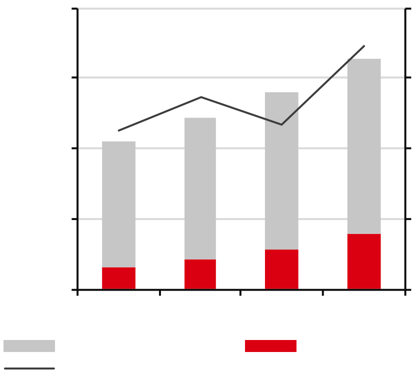
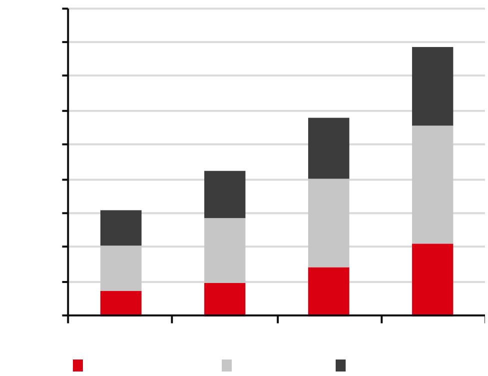


Exhibit 31: CSI emerging business revenue breakdown (RMBm)



We believe JF Platform will be the fastest growing sub-segment among all the three new businesses. Revenue growth will accelerate from 2020 once the ecosystem is more robust and offline customers are more used to online transactions and delivery. We are also positive about the growth outlook of cloud consultancy and implementation services as cloudification will start penetrating deeper among governments and SOEs due to the strong policy push.

GPM expansion to continue; OPM to remain flat on higher costs due to transformation
We forecast GPM will continue to improve to 31.0% this year due to strong growth in emerging businesses, which has a better margin profile than traditional IT outsourcing services. Going forward, margin expansion will mostly come from favourable changes of product mix. There is limited space for pricing hikes of traditional IT outsourcing services.

On OPM, we forecast it will be a flat to slight improvement for FY19-21e. CSI has largely -3(OP)-9(M)20(,) For non-GAAP adjustments, share-based compensation comprises the majority of the adjustments. The amount of share-based compensation will decrease going forward if there is no major change to business structure given most incentives have been awarded to key employees.

Payout will remain at 6- focus

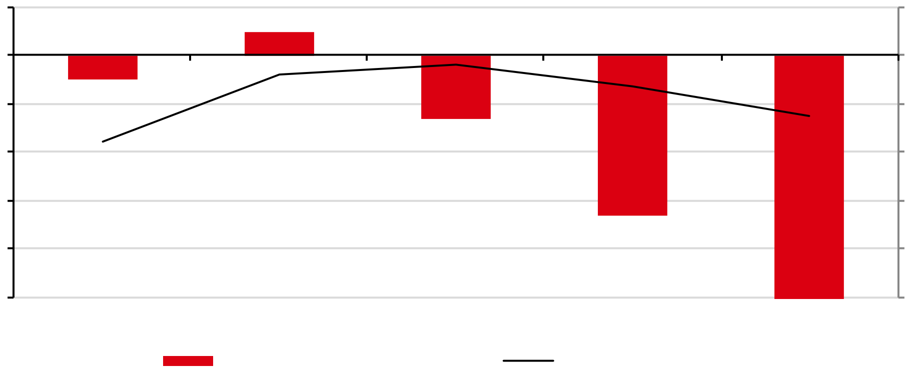
CSI started paying a dividend in 2017 (final dividend for FY16). The company now pays a dividend once a year. The payout was 7% for FY17-18 in RMB terms. We expect CSI to maintain the same payout level as FY17- and its ongoing transformation, most investors do not focus on cash returns at this moment.

Working capital management exerts pressure on FCF outlook

Working capital management is always a tough issue for IT services companies in China. The large number of employees working for CSI requires a significant amount of cash payment for their salaries and benefits every month. On the receivables side, the receivable days of different customers could vary a lot in China. Despite days sales outstanding having coB termvfor he

We expect the 2017 CB to be fully converted into CSI shares while the timing depends on market conditions. We also believe it is necessary for CSI to maintain the current level of short-term borrowing as part of its working capital management.

Exhibit 36: CSI gearing level



hibit 37: CSI summary P&L statement

Exhibit 38: CSI summary balance sheet statement

Disclosure appendix

Analyst Certification

The following analyst(s), economist(s), or strategist(s) who is(are) primarily responsible for this report, including any analyst(s) whose name(s) appear(s) as author of an individual section or sections of the report and any analyst(s) named as the covering analyst(s) of a subsidiary company in a sum-of-the-

Rating distribution for long-term investment opportunities

As of 08 July 2019, the distribution of all independent ratings published by HSBC is as follows:

Buy	52%	(30% of these provided with Investment Banking Services)
Hold	38%	(28% of these provided with Investment Banking Services)
Sell	10%	(21% of these provided with Investment Banking Services)

For the purposes of the distribution above the following mapping structure is used during the transition from the previous to current rating models: under our previous model, Overweight = Buy, Neutral = Hold and Underweight = Sell; under our current model Buy
ncial

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12
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2 All market data included in this report are dated as at close 04 July 2019, unless a different date and/or a specific time of day is indicated in the report.

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