HSBC Global Research

8 July 2019

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Chinasoft Int'l Ltd (354 HK)

Initiate at Buy: Aiming for the clouds

Equities
IT Services

China

- China's flagship provider of traditional IT services, but looking to new businesses like cloud for the next leg of growth
- Worries about Huawei reliance have hit the share price, but we see concerns as overdone even if trade tensions worsen
- Initiate at Buy: PE-based TP of HKD5.59 implies 37% upside

China's IT services leader: As the name suggests, Chinasoft International (CSI) is the flagship provider of traditional IT services in China, getting most of its revenue from big clients like Huawei and Microsoft. It has posted double-digit revenue growth in the past decade but the market is fragmented as CSI holds just 4% market share.

Huawei jitters: One major concern for investors recently has been CSI's reliance on Huawei, with the telecom giant contributing just over half of CSI's revenues last year. CSI's share price has fallen by a quarter from its year-to-date high after the US imposed restrictions on Huawei, and the situation remains unclear. We forecast CSI's revenue growth from Huawei to slow down to 12%/9% YoY in FY19/20e from 15% in FY18. However, one aspect − we believe not well understood by the market − is that this revenue mostly comes from Huawei's R&D expenses, an area that is unlikely to see cuts as Huawei strives to be more independent on chipsets and operating systems. Such business streams could create new opportunities for CSI and partially offset some negative impact of the US ban.

New businesses, new growth: As part of its efforts to diversify away from concentration risk, CSI has also launched three initiatives in recent years to drive new business: 1) Cloud (cloud migration and cloud-based software solutions), 2) JointForce (a platform that connects up SMEs and local governments to software engineers), and 3) managing Big Data for clients. In FY18, new businesses generated revenue of cRMB1.6bn, accounting for 15% of total revenue. We forecast new businesses to grow at a 35% CAGR from FY18-21e and account for 24% of total revenue by FY21e.

Valuation and risks: Trading at a decade-low valuation at 11.5x FY19e earnings despite the promising cloud businesses, we see value and initiate coverage with a Buy rating. Our target price of HKD5.59 is derived from 14.7x FY19e non-GAAP earnings, with the target multiple set at 0.5SD below its historical trading average to account for slower net profit growth momentum (15.5% CAGR for FY18-21e) compared with historical data (30.4% CAGR for FY13-18). Our TP implies 37% upside from the closing price on 4 July 2019. We believe the market underestimates CSI's business resilience to changes in the external environment and the growth momentum of its new businesses. Key downside risks include any further slowdown from key customers. We think CSI's interim results – due to be announced in August – will act as a near-term share price catalyst.

INITIATE AT BUY

TARGET PRICE (HKD)	PREVIOUS TARGET (HKD)
5.59	-

SHARE PRICE (HKD)	UPSIDE/DOWNSIDE
4.08	+37.1%

(as of 04 Jul 2019)

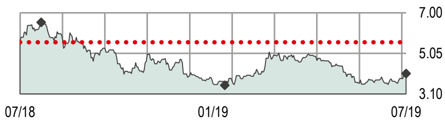
MARKET DATA

Market cap (HKDm)	10,381	Free float	76%
Market cap (USDm)	1,333	BBG	354 HK
3m ADTV (USDm)	8	RIC	0354.HK

FINANCIALS AND RATIOS (CNY)

Year to	12/2018a	12/2019e	12/2020e	12/2021e
HSBC EPS	0.30	0.31	0.34	0.43
HSBC EPS (prev)	-	-	-	-
Change (%)	-	-	-	-
Consensus EPS	0.28	0.31	0.35	0.41
PE (x)	12.1	11.5	10.5	8.4
Dividend yield (%)	0.0	0.0	0.0	0.0
EV/EBITDA (x)	8.5	7.3	6.3	4.8
ROE (%)	13.0	12.6	12.5	14.1

52-WEEK PRICE (HKD)



Target price: 5.59   High: 6.55 Low: 3.52 Current: 4.08

Source: Refinitiv IBES, HSBC estimates

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Financials & valuation: Chinasoft Int'l Ltd

Buy

Financial statements

Year to	12/2018a	12/2019e	12/2020e	12/2021e
Profit & loss summary (CNYm)				
Revenue	10,585	12,223	14,021	16,396
EBITDA	1,058	1,204	1,352	1,685
Depreciation & amortisation	-122	-126	-143	-164
Operating profit/EBIT	866	1,020	1,171	1,488
Net interest	-118	-138	-166	-203
PBT	760	894	1,018	1,300
HSBC PBT	0	0	0	0
Taxation	-44	-80	-107	-139
Net profit	721	809	907	1,156
HSBC net profit	721	809	907	1,156
Cash flow summary (CNYm)				
Cash flow from operations	161	482	682	904
Capex	-151	-244	-280	-328
Cash flow from investment	-16	-182	-224	-278
Dividends	-37	-52	-62	-69
Change in net debt	196	-357	-397	-556
FCF equity	-8	37	175	308
Balance sheet summary (CNYm)				
Intangible fixed assets	1,155	1,132	1,138	1,155
Tangible fixed assets	838	956	1,093	1,257
Current assets	8,225	9,953	11,212	12,621
Cash & others	2,666	3,580	4,035	4,499
Total assets	10,488	12,214	13,515	15,005
Operating liabilities	1,697	2,004	2,405	2,915
Gross debt	2,760	3,318	3,375	3,283
Net debt	94	-263	-660	-1,216
Shareholders' funds	5,967	6,823	7,660	8,728
Invested capital	5,854	6,458	7,004	7,620

Ratio, growth and per share analysis

Year to	12/2018a	12/2019e	12/2020e	12/2021e
Y-o-y % change				
Revenue	14.5	15.5	14.7	16.9
EBITDA	18.4	13.9	12.3	24.6
Operating profit	21.0	17.7	14.8	27.1
PBT	20.2	17.6	13.9	27.6
HSBC EPS	26.2	5.1	9.9	25.1
Ratios (%)				
Revenue/IC (x)	2.0	2.0	2.1	2.2
ROIC	16.5	15.9	16.1	18.6
ROE	13.0	12.6	12.5	14.1
ROA	8.6	8.3	8.2	9.4
EBITDA margin	10.0	9.9	9.6	10.3
Operating profit margin	8.2	8.3	8.4	9.1
EBITDA/net interest (x)	9.0	8.7	8.2	8.3
Net debt/equity	1.6	-3.8	-8.5	-13.8
Net debt/EBITDA (x)	0.1	-0.2	-0.5	-0.7
CF from operations/net debt	171.3			
Per share data (CNY)				
EPS Rep (diluted)	0.30	0.31	0.34	0.43
HSBC EPS (diluted)	0.30	0.31	0.34	0.43
DPS	0.00	0.00	0.00	0.00
Book value	2.46	2.64	2.90	3.25

Valuation data

Year to	12/2018a	12/2019e	12/2020e	12/2021e
EV/sales	0.9	0.7	0.6	0.5
EV/EBITDA	8.5	7.3	6.3	4.8
EV/IC	1.5	1.4	1.2	1.1
PE*	12.1	11.5	10.5	8.4
PB	1.5	1.4	1.2	1.1
FCF yield (%)	-0.1	0.4	1.9	3.3
Dividend yield (%)	0.0	0.0	0.0	0.0

* Based on HSBC EPS (diluted)

ESG metrics

Environmental Indicators	12/2018a
GHG emission intensity*	12.8
Energy intensity*	14.5
CO_2 reduction policy	Yes
Social Indicators	**12/2018a**
Employee costs as % of revenues	78.6
Employee turnover (%)	NA
Diversity policy	Yes

Governance Indicators	12/2018a
No. of board members	8
Average board tenure (years)	NA
Female board members (%)	12.5
Board members independence (%)	37.5

Source: Company data, HSBC

* GHG intensity and energy intensity are measured in kg and kWh respectively against revenue in USD '000s

Issuer information

Share price (HKD)	4.08
Target price (HKD)	5.59
RIC (Equity)	0354.HK
Bloomberg (Equity)	354 HK
Market cap (USDm)	1,333

Free float	76%
Sector	It Services
Country	China
Analyst	Colin Liu
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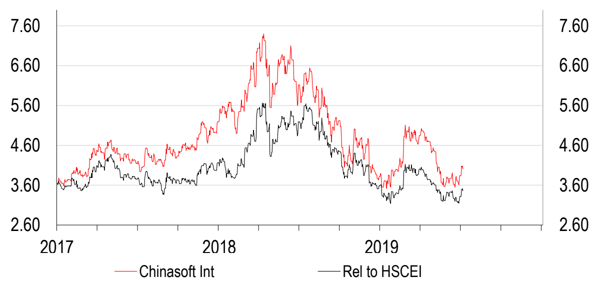
Price relative



Source: HSBC

Note: Priced at close of 04 Jul 2019

Contents

Investment summary

- Chinasoft set to further cement its leading position as China's premier IT service provider with robust growth…
- …while 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 the company's 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 CSI's revenue to grow at 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 that's been caught in the crosshairs of Sino-US trade tension (see *China and the US restart trade talks*, 29 Jun 2019). Huawei contributed 53% of CSI's total revenue 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 Huawei's R&D activities. Our analysis though suggests that it is the emerging business segments − which largely do not involve Huawei − 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 of "Solution as a Service" 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 a constructive view on CSI's emerging 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, CSI's strong relationships with key customers and 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

CSI's 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's revenue is mostly from the telecom giant's R&D activities that we see as 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 than the smartphone business. Huawei's telecom business has not been materially impacted at all, especially following President Trump's 30 June announcement that 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, we forecast CSI's revenue to grow 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.

Compared with consensus, we are more positive about the company's long-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 CSI's exposure to Huawei and a deep dive into CSI's Cloud as a Solution business. The near-term catalyst in our view is CSI's 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 a discount to A-share and Indian peers
- Initiate at Buy: PE-based valuation; target price of HKD5.59 implies 37% upside

Valuation

We use a PE-based valuation methodology to value CSI as we believe its earnings, and earnings growth, are critical indicators for the company's valuation. CSI's expansion into new businesses should also be reflected in its earnings. Over the last ten years, the shares' 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 of CSI's top customer. 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. The development of new businesses will help CSI's transformation, leading 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

Source: Bloomberg

- **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 CSI's transformation process and delay the potential re-rating opportunities.
- **Sharp RMB appreciation:** This would hurt CSI's competitiveness in overseas markets and lead to potential revenue decline in overseas markets.

Where are we different from consensus?

Exhibit 3: HSBC vs consensus

RMBm	2018a	2019e	2020e	2021e	18-21e CAGR
Consensus					
Revenues	**10,585**	**11,966**	**13,627**	**15,465**	13.5%
% chg YoY	14.5%	13.0%	13.9%	13.5%	
Operating Expense	**(9,527)**	**(10,779)**	**(12,270)**	**(13,894)**	13.4%
% chg YoY	14.1%	13.1%	13.8%	13.2%	
EBITDA	**1,058**	**1,187**	**1,357**	**1,571**	14.1%
% chg YoY	18.4%	12.2%	14.4%	15.8%	
% margin	10.0%	9.9%	10.0%	10.2%	
Operating Profit	**866**	**1,071**	**1,240**	**1,439**	18.4%
% chg YoY	21.0%	23.7%	15.8%	16.0%	
% margin	8.2%	8.3%	8.4%	9.1%	
Non GAAP Net Income	**777**	**830**	**976**	**1,183**	15.0%
% chg YoY	9.2%	6.9%	17.6%	21.1%	
Non GAAP EPS, RMB	**0.32**	**0.31**	**0.36**	**0.43**	10.0%
HSBC					
Revenues	**10,585**	**12,223**	**14,021**	**16,396**	15.7%
% chg YoY	14.5%	15.5%	14.7%	16.9%	
Operating Expense	(9,527)	(11,019)	(12,669)	(14,710)	
% chg YoY	14.1%	15.7%	15.0%	16.1%	
EBITDA	**1,058**	**1,204**	**1,352**	**1,685**	16.8%
% chg YoY	18.4%	13.9%	12.3%	24.6%	
% margin	10.0%	9.9%	9.6%	10.3%	
Operating Profit	**866**	**1,020**	**1,171**	**1,488**	19.8%
% chg YoY	21.0%	17.7%	14.8%	27.1%	
% margin	8.2%	8.3%	8.4%	9.1%	
Non GAAP Net Income	**777**	**854**	**947**	**1,196**	15.5%
% chg YoY	9.2%	10.0%	10.9%	26.3%	
Non GAAP EPS, RMB	**0.32**	**0.31**	**0.34**	**0.43**	10.3%
HSBC vs. Consensus					
Sales		2.2%	2.9%	6.0%	
EBITDA		1.5%	-0.4%	7.3%	
OP		-4.8%	-5.6%	3.4%	
Non GAAP Net Income		2.9%	-3.1%	1.1%	
EPS		0.6%	-4.5%	0.7%	

Source: Bloomberg, Company data, HSBC forecasts

Growth trajectory of emerging businesses to follow the "J-curve"

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 around CSI's top customer, 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

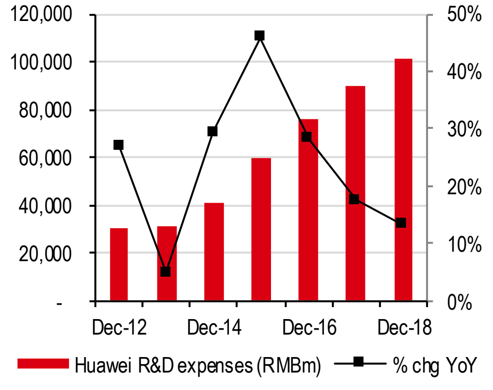
- While Huawei remains a key customer, and is responsible for over half of CSI's revenues…
- …we see only a modest slowdown for CSI in the short term due to US/Huawei issues and stay constructive over the long term…
- …and using modest assumptions we believe Huawei's own operating system could create 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.

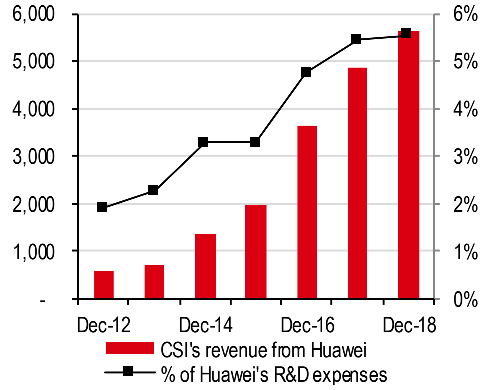
However, from the perspective of business strategy, this has led to significant customer concentration risk, especially in light of the recent US restrictions, and which is reflected in the discount we apply to our target multiple we use to value the stock. Over the past several years, Huawei's R&D spending has been increasing at a double-digit rate (except for 2013). CSI's revenue was equivalent to c5% of Huawei's R&D expenses by the end of 2018, with CSI mostly exposed to Huawei's telecom, chipset and cloud businesses.

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



Source: Company data

Exhibit 5: CSI's revenue and as a % of Huawei's R&D expense



Source: Company data

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 CSI's business with Huawei. Importantly though, this was simply a result of Huawei's 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 restrictions on CSI's largest customer.

Exhibit 6: Sensitivity analysis of CSI's exposure to Huawei (FY19)

YoY growth of revenue from Huawei	CSI overall revenue YoY growth	OP YoY growth	Reported Net profit YoY growth
15.0%	17.10%	19.4%	15.5%
12.0% (base case)	15.5%	17.7%	13.6%
6.0%	12.3%	14.3%	9.9%
0.0%	9.1%	11.0%	6.6%
-6.0%	5.9%	7.6%	2.5%
-12.0%	2.7%	4.2%	-1.2%

Source: HSBC estimates

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 added products and services. "Made in China 2025" is one of the earlier national strategic 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 saying he's confident that if they can't buy from the US 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

	2019	2020	2021
Market size of IOS and Android (RMBbn)	832	931	1,043
Huawei OS market size to IOS + Android	5%	7%	10%
Take rate	30%	30%	30%
% paid to IT service providers	15%	15%	15%
Addressable market size (RMBbn)	**1.9**	**2.9**	**4.7**

Source: Sensor Tower, HSBC estimates

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

The company's organisational structure is such that there are two major segments: TPG (Technical & Professional Services Group) and IIG (Internet IT Services Group).

- **TPG** provides services to the company's key clients such as Huawei, HSBC, Tencent, Alibaba, China Mobile and other large corporates across different industries.
- **IIG** is established around the JointForce platform, the company's IT service crowdsourcing 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)

	FY15a	FY16a	FY17a	FY18a
By reporting segment				
TPG	3,781	5,482	7,859	9,175
IIG	1,348	1,301	1,385	1,410
% of contribution				
TPG	73.7%	80.8%	85.0%	86.7%
IIG	26.3%	19.2%	15.0%	13.3%
% change YoY				
TPG	16.8%	45.0%	43.4%	16.7%
IIG	13.2%	-3.5%	6.4%	1.8%

Source: Company data

By the nature of its business, CSI's revenue can be categorised into "traditional IT services" and "emerging businesses". Traditional IT services mostly involves software outsourcing. Emerging businesses refer to JointForce, Cloud and Big Data.

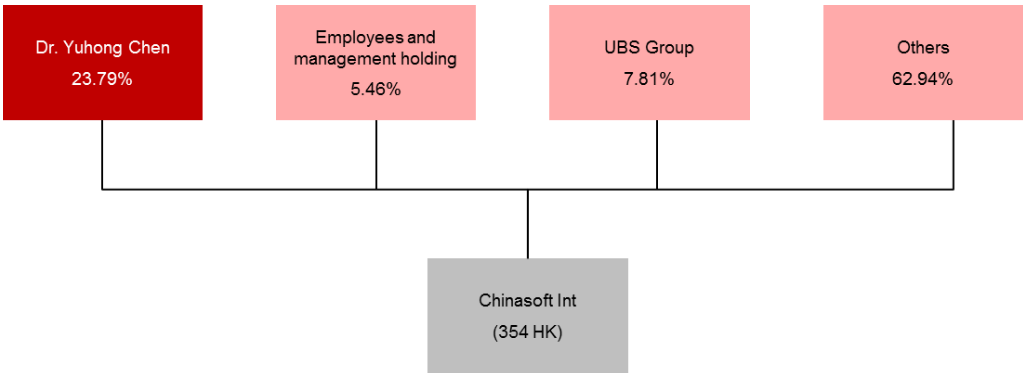
JointForce: This platform allows clients like SMEs and local governments to connect up directly with software engineers by using cloud-based crowdsourcing, aiming to capture the so-called long-tail of the IT Enterprise or government customers who can post software projects on the platform for registered engineers (either freelance or SME software developers). JointForce is able to facilitate online delivery and cloud software management. CSI has been dedicated to building up the ecosystems for software engineers and enterprise customers since it was launched in 2014. At this stage, JointForce is focusing on demand from local governments in China. By the end of 2018, there were 420k software engineers registered on JointForce and it expanded its offline Cloud Software Park coverage to 15 cities and regions.

Cloud: There are two major business lines under the Cloud segment: 1) Solution as a Service, and 2) cloud management and implementation service. For Solution as a Service, CSI provides customised solutions to enterprise customers across different industries. Solution as a Service is differentiated from traditional SaaS (software as a service) or PaaS (platform as a service) products as it directly addresses corporates' specific demands and can easily be integrated with customers' existing IT infrastructure.

CSI also provides cloud consulting and implementation services to its enterprise customers regardless of whether it is private cloud, public cloud or hybrid cloud. China started migrating to the cloud relatively late compared with some developed countries, particularly the US. CSI positions itself as a cloud solutions provider to help enterprises overcome different IT obstacles on their way to migrating to the cloud and sourcing the best cloud platform. Chinasoft primarily cooperates with Huawei's Cloud business in this area.

Big Data: With its dedicated data service team, CSI provides data strategy consultancy, analytics, platform management and implementation services to its customers. CSI's Big Data businesses cover different industries including banking, insurance, transportation, energy and so on.

Exhibit 9: CSI shareholding structure (as at 31 December 2018)



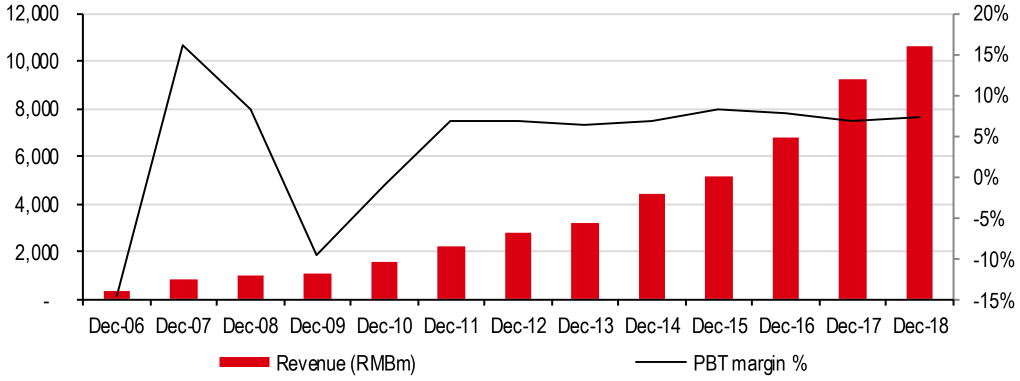
Source: Company data

A TMT veteran with a strong track record

In our view, the IT outsourcing services industry has been largely overlooked among all the sub-segments of China's TMT industry. It's a labour-intensive business, with fewer value-added touch points, a fragmented industry landscape and strong competition from Indian peers in international markets, a combination that has repelled most investors' interest.

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 the company's name suggests, it has become the flagship name for the IT services sector in China.

Exhibit 10: CSI's revenue and margin trends

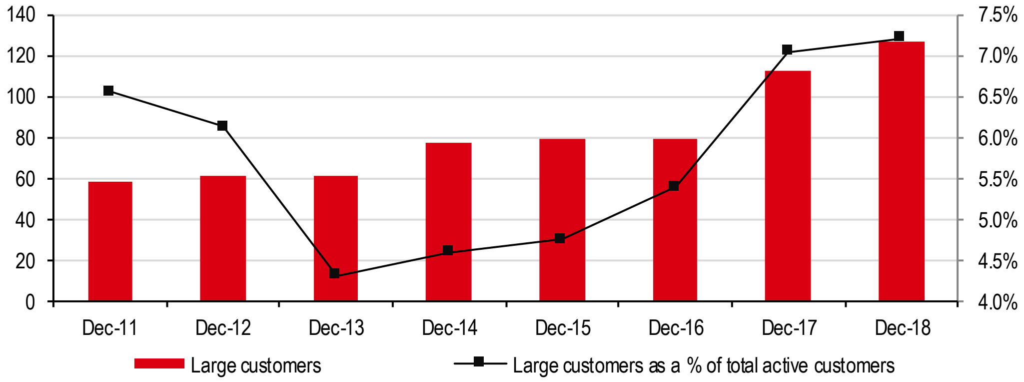


Source: Company data

By working with major customers, CSI is always close to edge-cutting technologies
One of CSI's key strategies is to grow by working closely with leading companies in different vertical groups. CSI built up strong relationships with and derived the majority of its revenue from a series of big names: Huawei (technology), China Mobile (telecom), Microsoft (software), Tencent (Internet), HSBC (banking), Ping An (insurance), and so on. This strategy enables CSI to constantly learn from its major customers and have a share in their growth over the last two decades, particularly digital inclusion (Digitalisation 1.0) and financial inclusion of mass consumers.

On the one hand, growing together with its major customers allows CSI to be aware of the most edge-cutting technologies and innovative business models even with limited capabilities as a medium-sized IT services company. On the other hand, this strategy helps CSI avoid direct competition with other TMT giants and secures ample space for its own development.

Exhibit 11: CSI's number of large customers



Source: Company data

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 together. Because of China's market depth, 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. These three vertical groups' capabilities in delivering cash 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 CSI's transformation

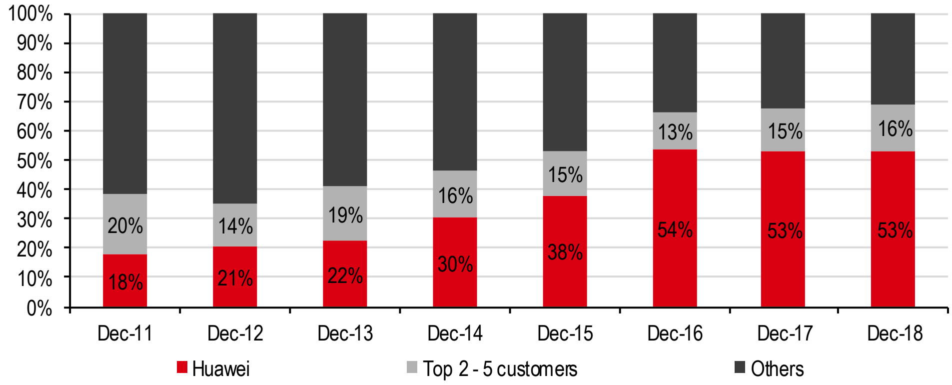
Success over the last decade may not always mean a promising outlook for the future

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 CSI's long-term growth outlook:

- **Highly concentrated in relation to Huawei:** For FY18, Huawei contributed 53% of CSI's total operating revenue. In fact, through the last decade, Huawei's contribution of CSI's 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 Huawei's business from the trade tensions between China and the US. However as we have explained above, CSI's business with Huawei is little affected and we expect CSI to continue to monetise Huawei's increasing R&D spending.

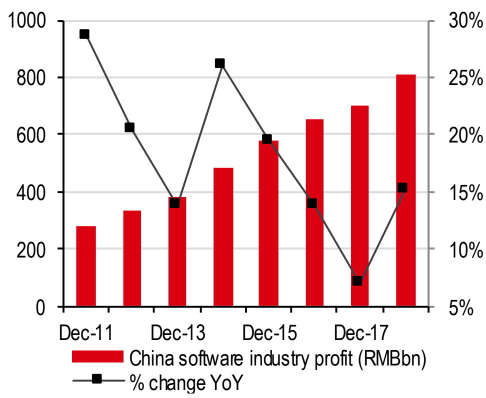
Exhibit 12: CSI revenue distribution among Huawei and other customers



Source: Company data

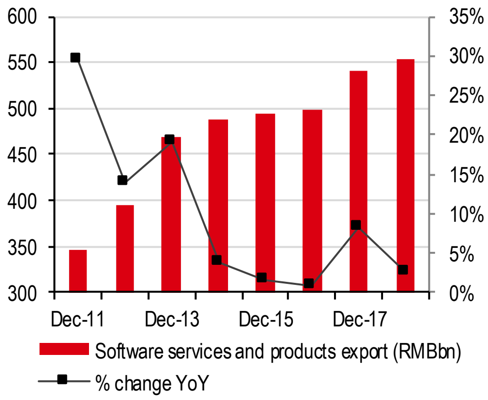
- **Traditional IT outsourcing growth is slowing down:** The slowdown in the labour-intensive IT outsourcing service industry is inevitable in our view. First, overall IT and software industry profit growth is slowing down after a period of solid and rapid growth in the domestic market. Second, customers 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, China's exports of IT services is also slowing down, removing a key growth engine.

Exhibit 13: China software industry profit



Source: MIIT

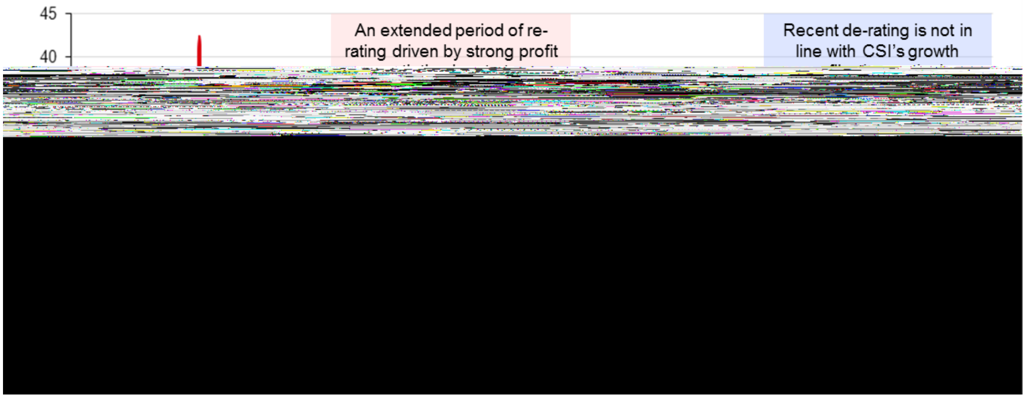
Exhibit 14: China software services and product exports



Source: MIIT

Capital markets seem to be very cautious about CSI's 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



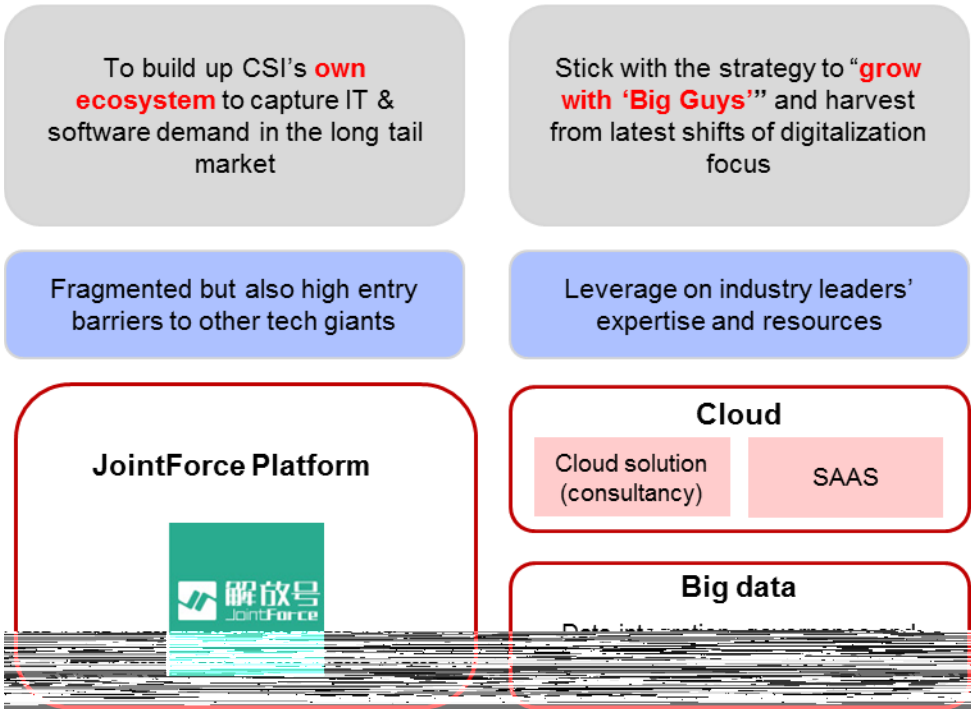
Source: Bloomberg

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 up its own ecosystem in relatively niche markets. JointForce is CSI's centrepiece in the making. The company has also launched its own SaaS products.
- **Expansion into emerging areas together with leaders from different vertical groups**. This includes the company's Cloud Solution and Big Data businesses.

Exhibit 16: CSI's two directions of self-transformation

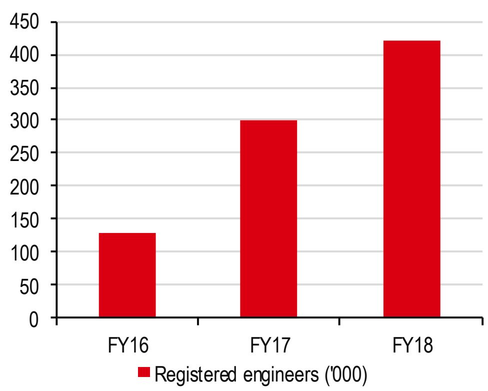


Source: Company data, HSBC

JointForce (JF): an innovative ecosystem as a solution to the tough long-tail IT market

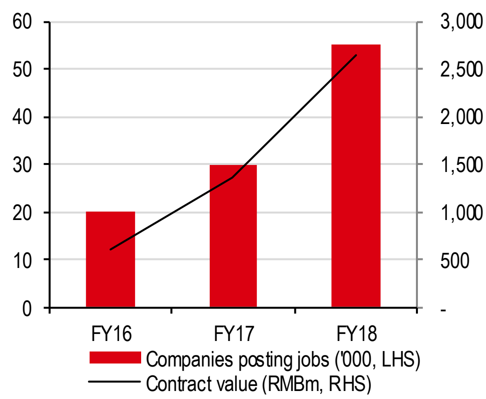
JF is an online-based IT services crowdsourcing platform. It was designed to enable communication and transactions between IT service vendors and corporate customers. Vendors on the JF platform could be a professional IT services company or freelance individuals. CSI is responsible for the background check of service vendors and ensures the quality of supply. On the demand side, CSI currently focuses on local governments and other public sectors. The platform is able to facilitate job matching, pricing and product delivery and payment. CSI also provides offline services and support, such as training and consultancy, complementing the JF platform. By the end of FY18, there were c420k software engineers providing services and c55k companies with job postings on JF's platform already.

Exhibit 17: Number of registered engineers on the JF platform



Source: Company data

Exhibit 18: Contract value and number of companies on the JF platform



Source: Company data

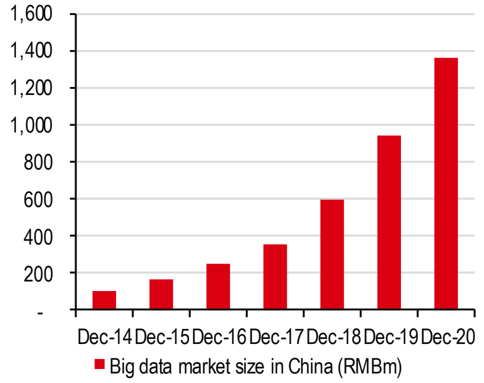
Cloud business to stay in line with the migration trend in corporate IT infrastructure
The second part of CSI's transformation initiatives is the cloud business. Apart from some SaaS applications launched by CSI, it mainly engages in cloud consulting and implementation services. As discussed in a previous 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-based platform. At this moment, CSI's role is to help its clients understand their cloud goals, and analyse their business structure and needs for cloud computing. After that, CSI will help clients achieve system integration and data transmission to the cloud platform.

CSI's cloud business works in close co-operation with Huawei. There are strong synergies between Huawei's IaaS (infrastructure as a service) cloud business and CSI's cloud initiative. With CSI's help, it becomes easier for Huawei's clients to increase their cloud adoption. In another sense, CSI completes Huawei's offering and differentiates other suppliers by its services. For CSI, cooperation with Huawei enhances their growth visibility, is in line with Huawei's interests and avoids direct competition with Huawei.

Big Data: Focuses on R&D of big data applications
As the third pillar of CSI's transformation, data analysis services from CSI include data strategy consultancy, data platform, data management and analytics. Current key customers mainly come from industries such as banking, insurance, securities, transportation, logistics and so on. It is currently the largest revenue contributor of the three segments.

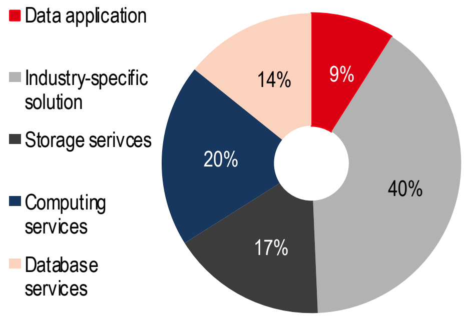
The potential market size is vast and is forecast to grow to almost RMB1.4trn by 2020. However, competition is also intensifying. Some are focusing on software; some on middleware; some dedicated to SaaS development; and some put more effort into platform development.

Exhibit 20: Big data industry market size in China (RMBbn)



Source: FB Intelligence

Exhibit 21: Global 'big data' industry breakdown



Source: FB Intelligence

Challenges ahead

Concentration risks still needs to be mitigated
As discussed above, exposure to and cooperation with Huawei has been a key growth driver for CSI. CSI's new business initiatives will help the company to diversify its customer portfolio. However, we do not expect the significance or revenue contribution of Huawei to decline in the next two to three years, regardless of the trade talk outcomes. CSI will have to demonstrate it is capable of acquiring and growing other large clients.

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

Strengths	Weaknesses
1) Long-time expertise in the IT services industry 2) Strong relationships with key customers, particularly banking, TMT and government customers 3) Stable and seasoned management team	1) Compared with international leading IT service providers, there is a gap due to cultural differences between CSI and its overseas clients 2) The labour-intensive nature of traditional IT services is hard to change in the short term

Opportunities	Threats
1) Demand for customised and solutions-oriented cloud services is rising 2) Big data market is growing much faster than traditional IT services industry	1) Competition level will intensify in China's big data market as more new entrants come into the market 2) US sanctions on Huawei and other of CSI's key customers may cause short-term disruption to CSI's traditional business

Source: HSBC

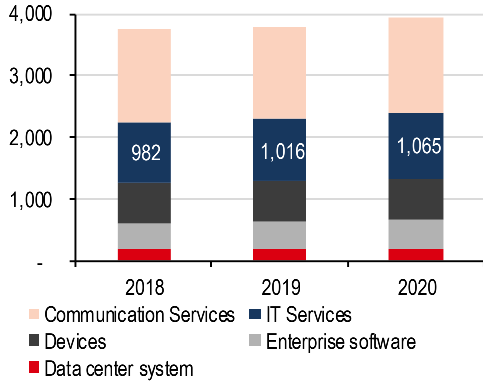
Broadening China IT services

- 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

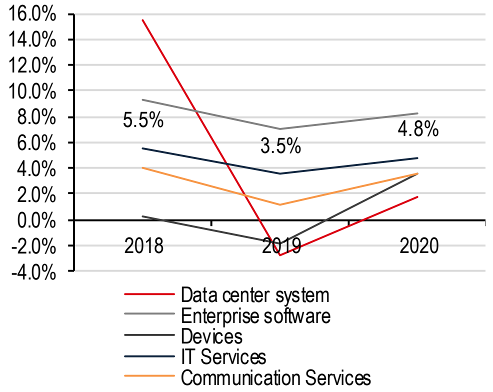
The traditional IT services industry has moved into a very mature stage globally. The global market size has grown to around USD1trn in recent years, according to Gartner, a third party vendor, with the YoY growth rate slightly higher than the global GDP growth rate. US companies with strong consulting 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)



Source: Gartner

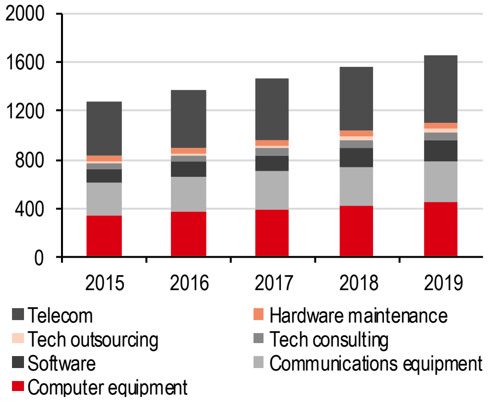
Exhibit 24: Global IT spending change YoY by category



Source: Gartner

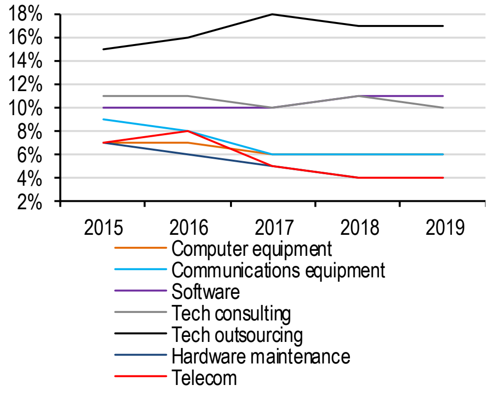
Due to rapid digitalisation in China, domestic IT services companies have shifted more of their focus to home markets. The growth of China's software product services exports has slowed down to low single digits in recent years. The market is fragmented as even though CSI is the largest IT services provider 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 25: Purchase of tech goods and services by business and government in China (RMBbn)



Source: Forrester

Exhibit 26: Purchase of tech goods and services by business and government in China, % change YoY



Source: Forrester

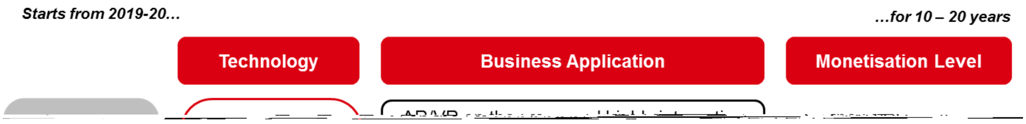
For CSI, its major competitors in the domestic IT service industry include: Pactera Technology (private), SoftStone (private) and Neusoft (600718 CH, not rated). As either some of them have delisted or do not provide a revenue breakdown, it is difficult to gauge their relative market position.

- **Pactera Technology:** The company is the merged entity of Hisoft Technology and VanceInfo. The merger was completed in 2012 and the company became the #1 market share leader in the China IT services industry. However, the company continued to suffer sluggish revenue growth and operating loss and in 2013 underwent privatisation.
- **SoftStone:** The company was founded in 2001 and employs over 50k staff now. It is one Huawei's key IT service providers. The company was listed on the NYSE in 2010 and completed its privatisation in 2014.
- **Neusoft:** The company engages in both IT outsourcing and self-developed software business. In FY18, the company generated revenue of RMB7.17bn, of which 83% comes from the software business and the rest from systems integration business.

Opportunities from migration to cloud-based IT infrastructure

As discussed above, both the global and China IT services industry are not generating the levels of fast growth they used to. It does not mean that overall corporate digitalisation is slowing down though. It actually reveals the shift of the digitalisation focus, especially in the 2B market (to business). In our last thematic report (*5G in China: Upgrading the national infrastructure*, 11 Feb 2019), we discussed how 5G and other advanced technologies are expected to be the focus of digitalisation trends in China. Correspondingly, we also expect there will be significant changes happening to corporates' IT infrastructure with the direction being more cloud-based.

Exhibit 27: China Digitalisation 2.0



Source: MIIT, HSBC

Exhibit 28: Cloud-based IT infrastructure in Digitalisation 2.0

Source: HSBC

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

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Company	Ticker	Recent price	Price date	Disclosure
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1. This report was produced and signed off by the author on 08 Jul 2019 10:20 GMT.

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MCI (P) 065/01/2019, MCI (P) 008/02/2019

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