

Traction at high-end products

China Software

Kingdee (268 HK, HK\$3.25)

Not Rated

Business model. Kingdee is a leading packaged software developer in China. The company is principally engaged in the development and sale of enterprise resource planning (ERP) applications. In addition, it offers software implementation, consulting and training services. Kingdee offers a vertically integrated suite of ERP products covering small to large enterprises. FY12/05 turnover reached RMB529.3m, up 18.7% YoY. KIS, K/3 and EAS accounted for 10.0%, 49.9% and 6.8% of turnover respectively. Software services accounted for 27.8% of turnover, while other software and hardware sales made up the remaining 5.5%.

Table 1: Product portfolio

Product	Quality range	Type	Customers	Functions
KIS	Low-end	ERP	Small enterprises	Financial software
K/3	Med	ERP	Small to med enterprises	Windows based comprehensive ERP solution comprising six modules, including finance, supply chain management, manufacturing, human resources and CRM
EAS	High-end	ERP	Med to large enterprises	Internet based, real time ERP solution with resources management, supply-chain management, customer resources management, knowledge management, and business intelligence functions. It offers horizontal and vertical integration
BOS/Apusic	Med to High-end	Middleware	Med to large enterprises	Communications layer that allows applications to interact across hardware and network environments

Source: Company data

Healthy industry growth. IDC projected China's ERP market to increase at a CAGR of 24% between 2004-2009. Management is more conservative and estimates that the market will increase at a CAGR of 18-19% over the next two to three years. By comparison, Kingdee's revenue grew at a healthy pace of 29.6% between FY12/01 to FY12/05. The company's strength is in the small and medium enterprises (SME) sector, where it is the largest provider with a market share of around 15-20%. Shanghai-listed UFIDA is ranked second, with a market share of 13-18%. SME make up over 95% of enterprises in China.

Price segmentation moderates competition. The ERP market in China is a price segmented market, which helps moderate the competitive landscape. Other than the low end sector, where competition is fierce, competition at other price points is rational as a few key vendors dominate their respective sectors. A case in point, SAP and Oracle dominate the large contract sizes of RMB7m+, while Kingdee and UFIDA are the major vendors for contract sizes of between RMB20k to RMB1m,

Distribution and direct sales extend geographical coverage. The company uses both distribution and direct sales to sell its ERP solutions. Kingdee utilises its 1,200 strong third party distribution network to sell KIS (mostly on an exclusive basis). The use of third party distributors has the advantage of expanding reach to lower tier cities and allows its direct sales force to focus on higher margin products such as K/3 and EAS. The seeding of KIS to SMEs in lower tier cities is strategically important to Kingdee to build brand name, foster loyalty and raise switching costs. The broadened customer base sets the scene for an up-sell to the mid-range K/3. Our read is that as its distributors develop more product knowledge, Kingdee may begin to sell K/3 through this third party distribution network. Kingdee's direct and distribution network covers 256 cities in China. The company has a diversified geographical portfolio with the greater Shanghai area,

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Shenzhen/Guangzhou and the greater Beijing area accounting for 28%, 18% and 18% of turnover respectively.

EAS on the verge of up take. The comprehensive version of EAS was effectively launched in 2H FY12/04. After an incubation period of around two years, we believe the product is on the cusp of becoming the company's next growth driver. Our industry checks indicated that both private enterprises and SOEs have begun to adopt EAS. These include Hopson (754 HK, HK\$15.28, NR), Bank of China (Guangdong) and Guangdong Auto amongst others. These are all leaders in their respective industries, which will improve the product's traction rate going forward.

Improving product mix driving services. K/3 and EAS sales have steadily increased from RMB237.9m in FY12/03 to RMB300.3m in FY12/05. The high customization and maintenance requirements associated with these products in turn drive services revenues. Services contribution is important as it represents a more stable source of income. Services revenue grew 24.9% YoY in FY12/05 to RMB147.1m and we expect this trend will continue going forward. Moreover, traction of the high-end EAS should further stimulate revenues from after sales maintenance services. The management aims to expand its revenue from services to 35% of turnover by 2010.

Kingdee has advantage over MNCs in SME sector. Kingdee generally does not compete head on with multi-national corporations (MNCs) such as SAP and Oracle due to price and customer segmentation. Though SAP and Oracle have been aggressive in trying to penetrate into the SME sector, there has been limited success thus far. We believe that Kingdee still holds a number of advantages, which should allow it to defend market share. 1) MNC ERP solutions are based on overseas "best practices", which differ from the common practices adopted in China. MNCs are reluctant to completely overhaul their products, preferring to maintain scale and standardization. Therefore, domestic developed solutions are often more suitable for SMEs; 2) MNC ERP solutions typically require more customization work. This will increase implementation costs from both time and engineering perspective. In general, implementation of Kingdee's EAS usually takes around four months while implementation of SAP/Oracle products can take up to 1 year.

QDII may benefit Kingdee. Kingdee is a beneficiary of the QDII scheme. With compatriot UFIDA being Shanghai-listed stock in China, Kingdee will be a leading second line target for Mainland fund managers on the HK stock market as they seek undervalued comparables to UFIDA. For FY12/05, Kingdee had a comparable profit growth to UFIDA while its profit margin of 13.7% (c. 10.1%) and ROE of 21.0% (c. 8.4%) were slightly better than its peer.

Capex plans. The company is currently undertaking construction of a R&D centre in Shanghai and a new headquarters in Shenzhen. The Shanghai R&D centre will cost RMB50m and will be completed in 2H FY12/07. The new Shenzhen headquarters is currently estimated to cost RMB100m and is scheduled to be completed in 2009. Kingdee's operations generate strong operating cash flow (FY12/05: RMB140.5m, up 20.4% YoY). The expansion will be funded mainly by internal resources. At the end of FY12/05, the company was in a net cash position of RMB256.7m (RMB0.578 cash per share).

Profit forecast. We expect Kingdee's profit to reach RMB 97.3m (EPS: RMB0.219) and RMB124.9m (EPS: RMB0.281) in FY12/06F and FY12/07F respectively, representing a growth of 34.6% YoY and 28.4% YoY. Increasing sales of EAS, middleware products and services will drive the profit. Though the higher proportion of services sales in its revenue mix will lead to a slight contraction in gross margin, we expect the company's operating margin to expand sequentially to 16.9% and 18.5% from the current 15.1% as the company begins to leverage operating scale.

Valuation. Kingdee is currently trading at 15.4x and 12.0x FY12/06F and FY12/07F P/E, a discount to the industry average of 19.0x and 17.0x (ex. UFIDA) based on consensus estimates.

Corporate governance issues. Kingdee was listed on the GEM Board in Feb 2001 and transferred over to the Main Board in July 2005. Founder and Chairman Xu Shao Chun is the largest shareholder with a 34.8% stake. Other substantial shareholders include Director, Zhao Yong (11.3%), Zhang Wen Xing (5.8%) and Schroder Investment Management (4.9%). The Chairman disposed of 3.5m shares at between HK\$2.90 to HK\$3.10 in May 2006. The company has not raised funds since listing and currently uses PricewaterhouseCoopers as its financial auditor. Kingdee does not have a strict dividend policy but paid out 20% of earnings as dividend over the past two years. The company has a prudent receivables policy and writes-off all receivables over 360 days.

Table 2: Valuation comparisons

Company Name	Ticker	Yr End	Mkt Cap (US\$m)	Price	Cur Yr P/E (x)	Next Yr P/E (x)
Oracle	ORCL US	May	76,584.4	US\$14.62	15.6	13.6
SAP AG	SAP GR	Dec	57,044.9	EURO140.65	23.4	20.0
SAGE	SGE LN	Sep	5,595.3	GBP229.25	18.0	17.5
UFIDA	600588 CH	Dec	549.7	RMB20.64	28.9	22.4
Average					21.5	18.4
Average (ex. UFIDA)					19.0	17.0
Kingdee	268 HK	Dec	185.7	HK\$3.25	15.4	12.0

Source: Bloomberg

Table 3: P&L

Year to Dec (RMBm)	2003A	2004A	2005A
Turnover			
Sales of software	296.9	323.8	377.1
Sales of hardware	5.2	4.3	5.1
Consulting & Services	39.5	33.6	44.7
Software implementation	24.0	84.2	102.4
	365.6	445.9	529.3
Cost of sales	(58.1)	(84.7)	(103.8)
Gross profit	307.5	361.2	425.5
Selling and distribution costs	(192.6)	(228.8)	(256.1)
Administrative expenses	(93.8)	(130.6)	(150.3)
Other operating expenses	48.3	57.3	61.1
Operating profit	69.4	59.2	80.1
Finance costs, net	-	(1.1)	(0.4)
Share of profits and losses of jointly controlled entities	-	-	-
Share of profits of an associated	(1.1)	(1.9)	0.1
Profit before taxation	68.2	56.3	79.8
Taxation	(10.2)	(3.3)	(6.6)
Profit after taxation	58.0	53.0	73.3
Minority interests	1.1	(1.3)	(1.0)
Profit attributable to shareholders	59.1	51.7	72.3
% chg	45.3	(12.5)	39.8
Dividend	(4.7)	(18.8)	(20.8)

Source: Company data