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Chinasoft: IT outsourcing powerhouse from China

Recommendation: BUY (initiating coverage) — **China Technology**

Price	**HK$1.90**
Target price	HK$2.95 (+55%)
12 mth range	HK$1.00-2.21
Market cap.	US$197.43m
Daily t/o, 3 mth	US$0.17m
Free float %	42.7%
Ticker	8216.HK/8216 HK

Year to Dec	Net profit+ RMBm	EPS* RMB	EPS Δ %	P/E x	P/B x	EV/EBITDA x	Yield %	ROE %	ROCE %	N. Gear. %
05A	39.7	0.054	15.8	33.1	4.6	25.2	0.6	16.1	15.6	Cash
06A	44.0	0.059	5.5	31.3	6.5	15.5	1.3	17.3	16.2	Cash
07F	92.6	0.104	76.8	17.7	2.5	7.8	1.7	21.4	20.3	Cash
08F	160.8	0.123	18.3	15.0	3.2	5.0	2.0	22.7	21.9	Cash
09F	197.4	0.151	22.8	12.2	2.7	3.9	2.5	23.7	22.9	Cash

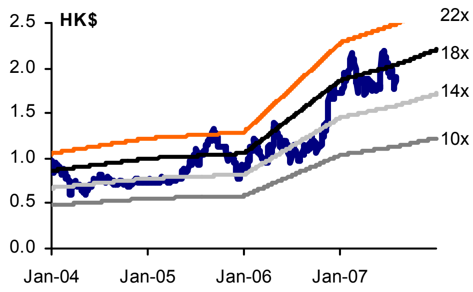
* *fully diluted EPS*
+ *Adjusted net profit excluding fair value gains/losses from convertible preference shares*
Relative to Hang Seng Index (1 mth, 3 mth, 12 mth): -4.2%, -1.5%, +40.9%
Actual price changes (1 mth, 3 mth, 12 mth): -2.6%, +7.3%, +86.3%
Consensus EPS (07F-08F): RMB0.102, RMB0.126

Key points:

- One of China's largest IT solutions and services providers with a staff of over 3,500. Microsoft and IFC are both strategic investors.
- Leveraging strong government connections, Chinasoft is a key solutions provider for the Chinese government. Business model ensures high vertical and horizontal adoption rate for its self-developed solutions.
- China's software offshore outsourcing market grew 48.4% YoY in 2006. IDC projects that the sector will grow at a CAGR of 37.4% between 2006-2011.
- Chinasoft is the leading IT outsourcing vendor for the North American/European regions. The sub-segment grew 93.6% YoY in 2006.
- HGR acquisition catapults Chinasoft into the forefront of the lucrative financial services sector. The need for Chinese banks to upgrade their IT infrastructure, coupled with their lack of internal expertise and experience, is expected to generate significant outsourcing demand.
- Leading status on several fronts including: 1) Chinese government IT market; 2) IT outsourcing from the fast growing North American region and 3) IT upgrade of China's financial services industry. Well positioned to become a powerhouse.
- Initiate coverage on Chinasoft with a target price of HK$2.95, representing 24.0x FY12/08F P/E on a fully diluted basis. China IT outsourcing and solutions stocks listed in Hong Kong trades at a massive valuation discount to their Mainland comparables despite being exposed to the same growth drivers.

Company background. Chinasoft is one of China's leading IT solutions and outsourcing companies. It is under the control of the State Council through a 24.6% stake held by China National Software & Services (CS&S). The company has two main business segments: 1) developing IT solutions for government controlled industries and SOE industries and 2) providing software outsourcing and business process outsourcing (BPO) services to reowned multi-national corporations (MNCs) such as Microsoft and IBM. The company was formed in Apr 2000 when 20 employees from CS&S were transferred to Chinasoft International Ltd. The newly formed company then established a Beijing JV as to 85% owned by Chinasoft and 15% owned by CS&S. Chinasoft was listed on the GEM Board of the HKEx in Mar 2003. Chinasoft's

Chart 1: P/E bands



Source: SBI E2-Capital

Managing Director, Henry Chen Yuhong was previously a Senior Vice President and Director of CS&S.

Microsoft and IFC are strategic investors. In Jan 2006, Microsoft and International Finance Corp. (IFC), the private sector investment arm of the World Bank Group, invested in Chinasoft through a strategic investment of maximum US$35.0m, to be completed over 3 installments. The investment is in the form of Preference Shares, with a variable conversion rate and maturity period of 6 years. Dividend is payable at the rate of 5.5% per annum on the par value of the Shares (5 cents/share) on a quarterly basis. To date, the first tranche has been completed and each company has injected US$10.0m. When converted, each Microsoft and IFC will hold a 9.6% stake in the company. To avoid further dilution of equity stake to Microsoft and IFC, the Directors of the Chinasoft has decided not to proceed with the 2nd and 3rd tranche of the subscription agreement.

Revenue breakdown and 1Q FY12/07A. For 1Q FY12/07A, turnover surged 88.7% YoY to RMB119.0m as net profit increased 15.2% to RMB12.0m. IT solutions revenues jumped 135.1% YoY to RMB80.7m, accounting for 67.8% of overall top line. The massive jump in this segment was primarily due to a significant increase in hardware sales relative to the previous year. Excluding the hardware component however, IT solutions still rose a healthy 55.0% YoY. IT outsourcing totaled RMB33.5m, representing an increase of 40.1% YoY and accounting for 28.1% of overall revenues. Weighed down by the increased sales of lower margin hardware, gross margins fell 4.8 pct YoY to 39.3%.

Table 1: 1Q FY12/07A results

Three months to Mar	Turnover (RMBm)	Gross profit (RMBm)	Gross margin (%)	Pre-tax profit (RMBm)	Tax rate (%)	Net profit (RMBm)	EPS (RMB)	DPS (RMB)
1Q FY06	63.1	27.8	44.1	12.5	15.7	10.4	0.014	-
1Q FY07	119.0	46.8	39.3	14.8	15.2	12.0	0.016	-
YoY (%)	*88.7*	*68.3*		*18.7*		*15.2*	*14.3*	

Source: Company data

Table 2: Revenue breakdown (1Q FY12/07A)

Segment	Revenue (RMBm)	% of overall revenue	YoY chg (%)
IT solutions	80.7	67.8	135.1
IT outsourcing	33.5	28.1	40.1
IT consulting and training services	4.0	3.4	54.8
Standalone software products	0.8	0.7	(65.4)
Total	**119.0**	**100.0**	**88.7**

Source: Company data

Leading IT solutions provider for the Chinese government. Chinasoft's business model in the solutions segment is to develop customised IT solutions for the vertical value chains of government and SOE industries. The Chinese government's e-government initiative comprises 12 main projects with an aim to: 1) modernize and enhance efficiency; 2) increase the level of supervision of government expenditure and income and 3) strengthen the government's administrative platform for future development. The company's self-developed solutions are extensively deployed in government e-solutions, allowing the company to gain a commanding market share in key government controlled industries such as tobacco, auditing and quality. Chinasoft is able to secure these IT contracts by leveraging its relationship with CS&S. The company's major clients include State Tobacco Monopoly Administration, National Audit Office and General Administration of Quality Supervision. Over the years, Chinasoft has forged both a strong relationship and brand name within government departments, as well as developed an understanding of the specialized needs and required levels of customization for these government sectors.

Table 3: China's e-government initiative

E-government projects		
Macro economy management system	OA system	Tax
Card	Audit	Agriculture
Finance	Quality	Shield
Social insurance	Custom	Water

Source: Company data

Table 4: E-government industry exposure for Chinasoft's IT solution contracts in 1Q FY12/07A

Industry	Government client	Brief description of contract
e-Tobacco	State Tobacco Monopoly Administration, China Tobacco Chuanyu Industrial Corporation	❑ Development and implementation of RFID barcode scanning system for tobacco transportation ❑ Development and implementation of information resources management system
e-Audit	4 provincial audit bureaus and 15 city audit bureaus	❑ Implementation and deployment work of OA system ❑ Experimental project for audit data planning for nationwide land tax intranet
e-Insurance	Xinjiang Production and Construction Corp	❑ Development and implementation of the core application of Phase I of the e-Insurance project based on data requirements and standards of Ministry of Labour and Social Security
e-Macro	State Administration for Industry and Commerce	❑ Phase I for the development of information resources sharing among the macroeconomic administration bodies

Source: Company data

New wave of government spending on e-solutions in 2007. According to IDC China, government IT spending totaled RMB35.8b in 2006. By 2011, this figure is expected to reach RMB61.4b, representing a 5-year CAGR of 11.4%. Moreover, the independent researcher expects government spending on IT solutions to be particularly strong in 2007, as the government gradually transform its role from administration to more service oriented. The latter requires increased transparency and information sharing between departments, leading to increased demand for IT solutions. Other factors include: 1) the commencement of implementation of the State e-government standardization project (after completion of Phase I in 2006), to allow government information interoperability; 2) continuing implementation of various e-government application systems; 3) increasing willingness for government agencies to invest in software development and the associated needs for customization.

Top down strategy reinforces adoption. Chinasoft adopts a top-down strategy whereby it gains approval of its self-developed solutions at the bureau level and then deploys the platform vertically throughout the industry chain under the mandate of the bureau or governing authority. The strategy adopted is typically a 3 stage process (project, program and partnership). In Phase I (project phase) the focus is on designing the overall IT architecture and the development of the IT framework, backbone and hub infrastructure. Importantly, it is during this initial stage where the company "drives" the adoption of the IT solution by the respective government departments. For Phase II (program phase), the customized features and applications are incorporated and the solution is initially deployed for key industry participants (nodes) and connected to the central hub. Finally, in Phase III (partnership), Chinasoft effectively becomes the execution partner for the government bureau/key participants and assists in the deployment of the solution to all end nodes. By first obtaining endorsement of the platform at the bureau level, Chinasoft's solution effectively becomes the defacto national standard for the particular sector/industry. This is a significant advantage as all subsequent applications and third party software will be built based on this platform. This will enhance its cost advantages during the Phase II and III rollout as only limited marketing and selling expenses are required. In terms of the cost structure, the IT solutions segment can generally derive a gross margin of between 45-60% depending on the amount of hardware included in the sales solution.

Government IT solutions the traditional cash cow for Chinasoft. The government IT solutions segment has traditionally been Chinasoft's cash cow segment providing the company with strong growth. Between FY12/03A and FY12/05A, the segment grew at a CAGR of 61.9% to RMB301.1m. In FY12/06A, revenues dropped 35.7% as the company concentrated on selling software solutions only (excluding hardware). The upshot to this strategy was that FY12/06A gross margins surged 16.6 pct YoY to 47.5%.

IT outsourcing adds another growth driver to the business model. Chinasoft offers a full suite of outsourcing services, including applications development management (ADM), enterprise applications services (EAS) and business process outsourcing (BPO). Around 80% of the company's outsourcing revenues are derived from overseas MNCs, mainly from North America and Europe. Client base includes Microsoft, Nokia, IBM, Motorola (China) and Huawei. The company has grown this segment both organically (as China increasingly becomes an outsourcing destination for overseas MNCs) and through M&As. The IT outsourcing segment grew 141.1% YoY in FY12/06A to RMB127.8m and 40.1% YoY to RMB37.7m in 1Q FY12/07A. The company's top 3 clients account for around 70-80% of the segment's revenues. Gross margins are varies between 25-40% depending on the type of outsourcing services.

China's IT outsourcing industry expected to grow at 37.4% CAGR from 2006-2011. According to IDC, China's software offshore outsourcing market grew 48.4% YoY in 2006 to US$1,384.2m. Moreover, the research firm has predicted that growth momentum would be sustained and projected the industry to grow at a 37.4% CAGR from 2006-2011. Market size is expected to total US$6,9414.8m by 2011. Key drivers include: 1) strong growth from North America and Europe; 2) industry consolidation and M&As and 3) steady growth from Japan and Korea.

Industry fragmented, but scale is hard to come by. Though China's IT outsourcing industry is fragmented, large incumbent players are scarce. Out of around 10,000 service providers, only 5 companies have more 2,000 employees according to CCID. At present, Chinasoft has around 3,500 employees (including over 2,100 in the IT outsourcing segment), making it one of the largest IT services company in China.

Japan and Korea still the largest outsourcing, but North America / Europe expected to be the stars. Japan/Korea has a long history of outsourcing IT work to China in part due to the geographical proximity, as well as linguistic and cultural similarities. At the end of 2006, Japan/Korea remain the largest contributors to the industry, accounting for 55.8% of the market, most of which came from Japan. Though North America and Europe only accounted for 35.8% of the IT outsourcing market in China, the segment grew some 93.6% YoY in 2006. This growth was mainly driven by a combination of both direct overseas contracts and contracts with China based MNCs. In this respect, Chinasoft is the leading vendor serving the North America / Europe region in 2006 with a 6.3% market share according to IDC. We expect this region to be one of the key drivers of IT outsourcing in China.

Table 5: IT outsourcing market share in China (2006)

Overall	(%)	North America / Europe	(%)	Japan / Korea	(%)
Neusoft	6.8	**Chinasoft**	**6.3**	Neusoft	11.0
DHC	4.3	Worksoft	5.1	DHC	7.1
Achievo	3.3	Achievo	5.0	Sinocom	4.7
Hisoft	3.3	Hisoft	4.5	Hisoft	2.9
Chinasoft	**2.9**	Augmentum	3.8	Chuwa	2.9
Sinocom	2.9	Beyondsoft	3.7	Achievo	2.4
Worksoft	2.3	Insigma	3.0	Insigma	1.3
Insigma	1.8	Objectiva	2.	**Chinasoft**	**1.2**
Chuwa	1.6	Neusoft	1.9	VSC	1.0
Beyondsoft	1.5	iSoftstone	1.6	iSoftStone	1.0
Others	69.3	Others	62.4	Others	64.5
Total	100.0	Total	100.0	Total	100.0

Source: IDC

Domestic demand the key differentiator from India. Though China still lags behind India in terms of outsourcing scale and project management quality in large scale projects, it has a competitive niche that India cannot replicate. China's lucrative domestic market is a target for many MNCs to introduce their IT products into the China. Chinese software outsourcing vendors can therefore tap these opportunities to offer localization, testing services, while leveraging their familiarity of the local market. Moreover, with many MNCs already owning sizeable manufacturing bases on the Mainland, this has translated to a huge demand for back office and data entry support at the door step of China's IT industry. Meanwhile, many local companies also outsource IT functions to third party vendors to maintain cost competitiveness. The demand is such that IT outsourcing demand from domestic sources accounted for 42.5% of the industry in 2006, growing 30.3% YoY. This percentage is significantly higher than the equivalent for India.

Table 6: China IT outsourcing market breakdown by outsourcer location

Location	2005		2006		YoY chg
	Revenue	(%)	Revenue	(%)	(%)
Domestic	451.5	48.4	588.3	42.5	30.3
Overseas	481.3	51.6	795.9	57.5	65.4
Total	**932.8**	**100.0**	**1,384.2**	**100.0**	**48.4**

Source: IDC

China IT outsourcing market drivers. North America companies have increasingly shifted its lower end IT outsourcing work to China and we expect this geographical segment to be the key driver going forward. The reasons for this includes:

- Offset rising outsourcing costs in India;
- Risk diversification;

- Take advantage of the low cost talent pool in China;
- Limited resources of MNC subsidiaries in China will necessitate that they retain key resources to focus on high end functions while outsourcing low end functions;
- Executives of MNC subsidiaries in China are typically overseas trained locals. They are familiar with both the MNC requirements and culture of the IT outsourcing vendors;
- Large scale investment in technical education in IT services by the government.

India outsourcing firms having difficulties establishing in China. Perhaps as a testament of the local knowledge required to operate successfully in China, many renowned India firms that have established a base in China are still struggling to ramp up. Based on our channel checks, Satyam (China) is still operating at a loss despite setting up in China as early as 2004. Meanwhile, Infosys, one of the world's leaders in IT outsourcing, was also recording a loss in 2006. Similar to other IT industries such as the Internet, foreign entities without local knowledge operate at a significant disadvantage in China. Thus, we see the IT outsourcing industry in China evolving in a similar manner to the Internet industry whereby foreign firms partner with local leaders such as Chinasoft to jointly develop the Mainland market. From the perspective of Chinasoft, such partnerships would offer opportunities to gain exposure to top level clients, as well as management execution of global projects.

India advantages slowly eroding while other emerging players have relative disadvantages. The rapid growth of China's IT outsourcing industry has meant that some of India's previous advantages are slowly being eroded. In terms of talent pool, some report indicates that two years from now, 200,000 IT professionals will graduate in China per year, where as India is only expected to produce 30,000 engineers and 100,000 IT professionals per year. The English linguistic level of the new graduates in China are expected to be better, which would alleviate much of the communications concerns of many MNCs. Meanwhile, India is facing: 1) "brain drain" of its IT professionals to overseas countries; 2) rising wages; 3) high attrition rates 4) rising Rupee against the US dollar, making its services increasingly expensive and 5) poor infrastructure. Other emerging countries on the other hand, such as Malaysia, do not have the domestic demand or the geographical scale to sustain the growth of the industry long term.

Table 7: Disadvantages of other emerging IT outsourcing destinations

Country	Disadvantages
Malaysia	❑ Lacks scalability given that it is a relatively small country
	❑ Software and hardware piracy issues rampant
	❑ Lack of domestic demand (relative to China) to sustain long term growth of industry
Czech Republic	❑ Average wages higher than China
	❑ Substantial political risk
	❑ Lacks scalability given that it is a relatively small country
	❑ Lack of domestic demand (relative to China) to sustain long term growth of industry
Poland and Hungary	❑ Uncertain business environments
	❑ Poor infrastructure
	❑ Lack of domestic demand (relative to China) to sustain long term growth of industry

Source: SBI E2-Capital

China can mitigate rising wages. Currently, wages for IT staff are between 15-40% cheaper than India, whose wages are rising rapidly due to skills shortage and brain drain to overseas MNCs. Though wages in China for IT staff are also rising, relocating staff to technology hubs in 2nd to 3rd tier cities can mitigate this impact. Already, IT outsourcing hubs are already been set up in Chengdu, Hangzhou, Jinan, Nanjing and Xian amongst others. In effect, much of these new hubs are not driven by cost pressures but by clients, as many MNCs are now setting up their offices in these 2nd tier cities and IT outsourcing vendors are merely sustaining their service levels to their clients by following them to these areas.

Strategic selection of M&A targets minimizes integration risk. Chinasoft has been making strategic acquisitions to boost scale and capabilities. The acquisition consideration is typically a combination of cash and shares with earn out clauses, a standard practice in the IT industry. We are positive on the acquisitions given that it rounds out the company's outsourcing service profile and broaden its customer base. The company has made four acquisitions in the past 18 months. However, each acquisition is strategically selected to either add value horizontally (ie. new market segments) or vertically (new services eg. ADM for mobile sector). This is a sound strategy the acquisition targets typically have little or no overlap with Chinasoft's existing services profile, which would minimize integration risk caused by profile conflict.

Table 8: Chinasoft's acquisitions in 2006

Company	% Stake	Consideration	Valuation	Description of operations
Cyber Resource	From 26-76%	HK$36.6m Cash (w/ earn out clause)	10.8x FY12/05 P/E	Software development, testing, localization and call centre services. Clients include IBM, Motorola, Panasonic and Epson
Powerise	100%	HK$7.8m	4.5x FY12/05 P/E	Software design, testing and business process outsourcing services with focus on the Japanese market. Clients include NEC
Opportune Technology	100%	HK$23.4m Cash and shares (w/ earn out clause)	0.94x FY12/06F sales	Software outsourcing services for Microsoft's Mobile and Embedded Division (MED) and for other mobile communications equipment developers.
Hinge Global Resource (HGR)	100%	US$55.0m max (subject to adjustments) Cash and shares (w/ earn out clause)	15.5x FY12/07F P/E	Software outsourcing and business process outsourcing (BPO) for the banking and finance industry. Approximately 1,300 staff

Source: Company data

HGR acquisition catapults Chinasoft into the banking and finance sector. In Jan 2007, Chinasoft announced the 100% acquisition of Hinge Global Resource (HGR) for a maximum consideration of US$55.0m (subject to adjustments). Headquartered in Shanghai, HGR is a leading ADM and BPO outsourcing vendor for China's banking and finance industry. With a staff of around 1,300, the company is one of the largest IT outsourcing vendors for the financial services industry (FSI) in China. HGR's blue chip clients include: China UnionPay, Bank of Communications (3328 HK, HK$8.43, NR), Agricultural Bank of China, China Post and Shanghai Social Security Smart Card Service Centre. It also has a division focused on the Japanese sector, providing CAD design services for large telecommunications and engineering companies such as Meitec Corp and NTT Communications Corp. The acquisition comprises a maximum of US$5.5m cash with the remaining to be settled by consideration shares. Assuming maximum earn out, the valuation of the consideration will represent 15.5x FY12/07F P/E. While the consideration valuation is somewhat higher than previous acquisitions made by the company, we believe when taking into consideration: 1) scale of HGR; 2) strategic focus on the banking and finance sector; 3) portfolio of clients and 4) the opportunity cost of breaking into this sector and growing it organically, the acquisition of HGR warrants a premium.

Financial details of HGR. In FY12/06A, HGR recorded a turnover and net profit of RMB283.6 and RMB21.5m respectively. The net margin of 7.5% is lower than of Chinasoft's but this is largely due to its high unallocated corporate expenses. Once the acquisition is closed, we expect Chinasoft to be able to leverage economies of scale to rationalize and eliminate some of these corporate expenses. This will enable Chinasoft to gradually drive up it's the margins of HGR going forward. We are currently expecting the acquisition to be closed by the end of Aug 2007.

Demand from financial services sector expected to be significant. In our view, the FSI sector offers tremendous growth prospects for the IT outsourcing industry. At present, there are an estimated 35,000 bank branches in China, though most lack basic IT infrastructure. On the demand side, with the gradual opening up of the banking sector to foreign competition, local competition from private banks and the privatization of SOE banks, competition within the sector is expected to significantly increase going forward. Therefore, there is a tremendous momentum for existing Chinese banks to upgrade their IT infrastructure and leverage more efficient platforms to deliver better customer services, improve margins, just to survive the competition. Moreover, many Chinese banks have just raised funds from the capital markets and therefore have the budgets to undertake the IT upgrade. On the supply side, facing too many priority projects, Chinese banks are often willing to outsource ADM and BPO projects to third party vendors. This outsourcing is further driven by the lack of internal expertise on the latest approaches in key operating areas such as internet service platforms, consumer data consolidation and processing. Therefore, we expect this lack of strong internal IT resources, experience, systems and processes in the FSI to drive outsourcing demand, benefiting leaders such as Chinasoft.

Consolidation year in FY12/08. After an aggressive M&A strategy in FY12/06 and FY12/07, we expect Chinasoft to concentrate on integration and extracting acquisition synergies in FY12/08. Thus we expect any M&As actions by the company, if any, to be small in scale.

P&L forecasts. For our P&L forecasts, we have assumed that Microsoft and IFC has fully converted their preference shares. Therefore, there would be no gains/losses arising from changes in fair value of redeemable convertible preference shares booked on the P&L. For FY12/07F, we are estimating Chinasoft to record a net profit of RMB92.6m off a turnover of RMB778.2m (incorporating a 4.5 month contribution from HGR). IT solutions segment is estimated to surge 164.2% YoY to RMB511.3m and IT outsourcing is estimated to contribute RMB232.8m, up 82.1% YoY. With a full year contribution from HGR in FY12/08, we are projecting FY12/08F net profit to rise 73.7% YoY to RMB160.8m, driven by: 1) full year contribution from HGR; 2) continue robust growth in both Chinese government IT spending and overseas outsourcing to China and 3) margin expansion from acquisition synergies. Turnover is forecast to rise 49.9% YoY to RMB1,166.6m with IT solutions accounting for 64.3% (RMB749.6m) and IT outsourcing accounting for 32.6% (RMB380.3m) of top line.

Initiating coverage with BUY call, target price HK$2.95. With leading status on several fronts including: 1) Chinese government IT market; 2) IT outsourcing from the fast growing North American region and 3) IT upgrade of China's financial services industry, we believe Chinasoft is well positioned to become a power player with global recognition. We initiate coverage on Chinasoft with a target price of HK$2.95, representing 24.0x FY12/08F P/E on a fully diluted basis (assuming the conversion of Microsoft/IFC preference shares, amounting to a total of 194.5m shares and the issue of 306.1m consideration shares for the HGR acquisition). In our view, there are significant latent value waiting to be unlocked in the counter as China IT outsourcing and solutions stocks listed in Hong Kong trades at a significant valuation discount to their Mainland comparables despite being exposed to the same growth drivers. The counter is currently trading at an undemanding 15.0x FY12/08F P/E fully diluted.

Corporate governance issues. Chinasoft was listed on the GEM Board in June 2003. At present, the company's substantial shareholders include CS&S (24.6%), Far East Technology (16.1%), ABN AMRO Holdings N.V. (6.0%) and Zhou Qi (5.8%). However, after Microsoft and IFC converts its Preference Shares, the shareholding structure for the substantial shareholders will be diluted to CS&S (19.8%), Far East Technology (13.0%), Microsoft (9.7%), IFC (9.7%), while previous substantial shareholders ABN AMRO and Zhou Qi will be diluted to below the 5.0% threshold. The company has used Deloitte as its financial auditor since its IPO and has not raised further funds from the equity market. The company paid a flat dividend of HK$0.01 in FY12/04 and 48.0% of earnings in FY12/05A, but has pledge to maintain a payout ratio of 30% going forward.

Table 9: P&L

Year to Dec (RMBm)	05A	06A	07F	08F	09F
Turnover					
Solutions	301.1	193.5	511.3	749.6	848.8
Outsourcing	53.0	127.8	232.8	380.3	543.1
Consulting & Training Services	7.6	12.2	16.7	18.8	20.7
Sales of Standalone Software	20.6	21.7	17.5	17.9	17.6
	382.3	**355.2**	**778.3**	**1,166.6**	**1,430.2**
Cost of sales	(264.3)	(186.3)	(436.6)	(689.2)	(857.0)
Gross profit	118.0	168.9	341.7	477.4	573.2
Other operating income	4.6	9.1	15.7	32.4	46.9
Distribution costs	(18.9)	(20.6)	(33.3)	(44.5)	(42.9)
Administrative expenses	(44.6)	(78.1)	(161.7)	(244.7)	(310.4)
Amortization of intangible assets	(3.0)	(8.4)	(17.3)	(22.6)	(25.7)
Amortization of goodwill	-	(1.0)	(24.7)	(23.5)	(22.3)
Allowance for doubtful debts	(9.3)	(2.0)	(2.5)	(3.5)	(4.5)
Other exceptional items	-	(1.1)	-	-	-
Operating profit	46.9	66.9	118.0	198.0	241.2
Finance costs	(0.0)	(10.8)	(8.5)	(8.6)	(8.6)
Share of profits and losses of jointly controlled entities	-	-	-	-	-
Share of profits of an associates	1.8	2.5	0.9	-	-
Adjusted profit before taxation *	**48.7**	**58.6**	**110.3**	**189.4**	**232.6**
Taxation	(5.7)	(11.9)	(14.9)	(23.7)	(29.1)
Adjusted profit after taxation *	**43.0**	**46.7**	**95.4**	**165.8**	**203.5**
Minority interests	(3.3)	(2.7)	(2.9)	(5.0)	(6.1)
Adjusted profit attributable to shareholders *	**39.7**	**44.0**	**92.6**	**160.8**	**197.4**
% chg	*24.8*	*10.8*	*110*	*73.7*	*22.8*
Gains/losses from changes in fair value of redeemable convertible preference shares	-	(110.6)	(83.0)	-	-
Profit attributable to shareholders	**39.7**	**(66.9)**	**9.6**	**160.8**	**197.4**
% chg	*24.8*	*n/a*	*n/a*	*1575.0*	*22.8*
Dividend	(7.4)	(18.3)	(27.8)	(48.2)	(59.2)

*" * " Excluding gains/losses from changes in fair value of redeemable convertible preference shares*

Source: Company data, SBI E2-Capital

Table 10: Peer comparison

Company name	Ticker	Market Cap (US$m)	Last Price (Local)	P/E (x) Historical	P/E (x) Est Cur-Yr	P/E (x) Est 1-yr Fwd	ROE (%)
China IT outsourcing / solutions							
Sinocom	299 HK	197.5	HKD1.44	21.0	15.3	13.1	21.1
Insigma Technology	600797 CH	1,063.2	RMB9.64	66.0	52.1	39.1	9.7
Shenyang Neusoft	600718 CH	1,570.7	RMB41.90	127.9	46.0	50.2	5.8
Bright Oceans Inter-Telecom	600289 CH	825.2	RMB21.48	67.9	44.9	40.6	7.8
Beijing Teamsun Technology	600410 CH	968.4	RMB22.14	49.6	40.1	28.4	19.6
Hundsun Electronics	600570 CH	455.1	RMB18.05	628	56.1	43.1	11.7
Yucheng Technologies	YTEC US	74.4	RMB7.80	n/a	15.2	10.8	n/a
Average				*65.8*	*38.5*	*32.2*	*12.6*
India IT outsourcing							
Tata Consultancy	TCS IN	26,515.5	INR1,115.80	25.5	21.1	17.2	56.7
Wipro	WPRO IN	16,684.1	INR475.70	22.4	19.8	16.1	34.8
Infosys	INFO IN	26,840.7	INR1,929.60	27.4	23.3	18.8	42.3
Satyam	SCS IN	7,699.9	INR469.70	21.7	18.6	15.3	30.7
Average				*24.3*	*20.7*	*16.8*	*41.1*
US IT solutions							
Accenture	ACN US	33,099.1	USD42.13	22.6	21.2	18.5	54.2
Computer Associates	CA US	13,288.8	USD25.08	25.7	25.7	23.5	2.8
BearingPoint	BE US	1,298.6	USD6.52	n/a	18.9	13.7	n/a
Citrix Systems	CTXS US	6,555.2	USD36.17	30.5	24.0	20.9	14.7
BEA Systems	BEAS US	4,990.2	USD12.38	26.5	25.1	22.3	13.3
Average				*26.3*	*23.01*	*19.8*	*21.3*
Chinasoft	8216 HK	197.4	HK$1.90	31.3*	17.7*	15.0*	17.3*

" * " *Fully diluted basis, excluding gains/losses from changes in fair value of redeemable convertible preference shares*

Source: Bloomberg

P & L (RMBm)	05A	06A	07F	08F	09F
Year to Dec					
Turnover	**382.3**	**355.2**	**778.2**	**1,166.6**	**1,430.2**
% chg	*30.1*	*(7.1)*	*119.1*	*49.9*	*22.6*
Gross profit	118.0	168.9	341.7	477.5	573.2
EBITDA	62.8	84.7	169.9	256.5	304.6
Depre./amort.	(6.6)	(15.8)	(49.4)	(55.0)	(58.9)
EBIT	56.2	68.9	120.5	201.5	245.7
Net int. income/(exp.)	(0.0)	(10.8)	(8.5)	(8.6)	(8.6)
Exceptionals	(9.3)	(2.0)	(2.5)	(3.5)	(4.5)
Associates	1.8	2.5	0.9	-	-
Jointly-controlled entit.	-	-	-	-	-
Adjusted pre-tax profit	**48.7**	**58.6**	**110.3**	**189.4**	**232.6**
Tax	(5.7)	(11.9)	(14.9)	(23.7)	(29.1)
Minority interests	(3.3)	(2.7)	(2.9)	(5.0)	(6.1)
Adjusted net profit	**39.7**	**44.0**	**92.6**	**160.8**	**197.4**
% chg	*24.8*	*10.9*	*110.5*	*73.7*	*22.8*
Dividends	(7.4)	(18.3)	(27.8)	(48.2)	(59.2)
Retained earnings	32.3	25.7	64.8	112.6	138.2
EPS (RMB) - Basic	0.056	0.059	0.104	0.123	0.151
EPS (RMB) - F.D.	0.054	0.059	0.104	0.123	0.151
DPS (RMB)	0.010	0.024	0.031	0.037	0.045
No. sh.s o/s (m) - W.A.	661.3	713.5	749.8	892.8	1,311.1
No. sh.s o/s (m) - Y.E.	739.4	732.4	758.8	1,224.1	1,311.1
No. sh.s o/s (m) - F.D.	667.9	730.7	749.8	892.8	1,311.1
Margins (%)					
Gross	*30.9*	*47.5*	*43.9*	*40.9*	*40.1*
EBITDA	*16.4*	*23.8*	*21.8*	*22.0*	*21.3*
EBIT	*14.7*	*19.4*	*15.5*	*17.3*	*17.2*
Pre-tax	*12.7*	*16.5*	*14.2*	*16.2*	*16.3*
Net	*10.4*	*12.4*	*11.9*	*13.8*	*13.8*

Adjusted numbers exclude the effect of loss arising from change in fair value of redeemable convertible preferred shares.

Balance Sheet (RMBm)	05A	06A	07F	08F	09F
Year to Dec					
Fixed assets	23.3	42.3	66.6	83.3	98.3
Intangible assets	18.0	48.9	57.4	70.5	79.7
Other LT assets	87.7	153.8	505.1	472.4	445.9
Cash	100.1	133.6	118.7	157.7	265.1
Accounts receivable	182.1	234.0	320.4	476.5	503.1
Other receivables	-	-	-	-	-
Inventories	22.7	34.1	61.6	85.3	102.5
Due from related co.s	1.8	-	-	-	-
Other current assets	3.1	14.5	3.0	4.0	1.0
Total assets	**438.8**	**661.2**	**1,132.7**	**1,349.8**	**1,495.7**
Accounts payable	(98.3)	(107.7)	(155.5)	(262.6)	(254.0)
Other payable	-	-	-	-	-
Tax payable	(2.8)	(4.7)	(3.0)	(2.0)	(3.0)
Due to related co.s	-	(0.5)	-	-	-
ST debts	-	-	-	-	-
Other current liab.	(26.8)	(43.6)	(26.7)	(23.0)	(32.0)
LT debts	-	-	-	-	-
Other LT liabilities	(1.8)	(271.1)	(271.0)	(272.7)	(273.8)
Total liabilities	**(129.7)**	**(427.6)**	**(456.1)**	**(560.3)**	**(562.8)**
Share capital	38.3	40.2	55.0	55.0	55.0
Reserves	256.2	172.7	595.7	708.3	846.5
Shareholders' funds	**294.5**	**212.8**	**650.7**	**763.3**	**901.5**
Minority interest	14.0	20.8	25.9	26.2	31.5
Total	**308.5**	**233.7**	**676.6**	**789.5**	**932.9**
Capital employed	308.5	233.7	676.6	789.5	932.9
Net (debt)/cash	100.1	133.6	118.7	157.7	265.1

Cash Flow (RMBm)	05A	06A	07F	08F	09F
Year to Dec					
EBIT	56.2	68.9	120.5	201.5	245.7
Depre./amort.	(6.6)	(15.8)	(49.4)	(55.0)	(58.9)
Net int. paid	(0.0)	(10.8)	(8.5)	(8.6)	(8.6)
Tax paid	(3.7)	(9.4)	(17.9)	(28.4)	(34.9)
Others	17.4	44.1	78.2	75.7	74.0
Gross cashflow	**63.3**	**77.0**	**122.8**	**185.2**	**217.3**
Chgs. in working cap.	(19.0)	(69.5)	(66.1)	(72.7)	(52.5)
Operating cashflow	**44.3**	**7.4**	**56.7**	**112.5**	**164.8**
Capex	(14.7)	(49.9)	(12.2)	(29.9)	(24.2)
Free cashflow	**29.6**	**(42.5)**	**44.5**	**82.6**	**140.6**
Dividends paid	(7.9)	(18.2)	(27.8)	(48.2)	(59.2)
Net distribution to MI	(3.3)	(2.7)	(2.9)	(5.0)	(6.1)
Investments	na	(80.6)	(35.0)	(7.8)	-
Disposals	-	0.1	0.1	0.1	0.2
New shares					
Others	na	182.4	12.8	23.9	24.0
Net cashflow	**28.2**	**38.4**	**(8.2)**	**45.6**	**99.5**
Net (debt)/cash - Beg.	74.0	100.1	133.6	118.7	157.7
Net (debt)/cash - End.	100.1	133.6	118.7	157.7	265.1

Interim Results (RMBm)	05A	06A
Six months to Jun		
Turnover	**163.5**	**133.8**
% chg	*na*	*(18.2)*
Profit from operations	19.0	28.0
Interest expenses	(0.0)	(0.0)
Associates	0.6	1.3
Jointly-controlled entit.		
Pre-tax profit	**19.5**	**29.3**
Tax	(1.3)	(4.7)
Minority interests	-	0.0
Net profit	**18.2**	**24.5**
% chg	*na*	*34.7*
EPS (RMB) - Basic	0.026	0.033
DPS (RMB)	0.011	0.026

Shareholding Structure	Shares o/s (m)	%
CS&S	199.0	24.6
Far East	130.2	16.1
ABN AMRO Holding N.V.	48.4	6.0
Zhou Qi	46.9	5.8
Public	346.1	42.7
Total	**810.5**	**100.0**

Background

Chinasoft is one of China's leading IT solution and outsourcing companies. The company has two main business segments: 1) developing IT solutions for government controlled industries and SOE industries and 2) providing software outsourcing and business process outsourcing (BPO) services to renowned multi-national corporations (MNCs) such as Microsoft and IBM.

Key Ratios	05A	06A	07F	08F	09F
Net gearing (%)	Cash	Cash	Cash	Cash	Cash
Net ROE (%)	16.1	17.3	21.4	22.7	23.7
EBIT ROCE (%)	22.1	25.4	26.5	27.5	28.5
Dividend payout (%)	18.6	41.6	30.0	30.0	30.0
Effective tax rate (%)	11.7	20.3	13.5	12.5	12.5
Net interest coverage (x)	na	6.4	14.1	23.5	28.7
A/R turnover (days)	144.3	213.8	130.0	125.0	125.0
A/P turnover (days)	121.8	201.7	110.0	111.0	110.0
Stock turnover (days)	39.5	55.6	40.0	39.0	40.0