

The next IT outsourcing destination**China Software****Chinasoft International (8216 HK, HK\$1.06)****Not Rated**

Business model. Chinasoft is one of China's leading IT solutions and outsourcing companies. It is under the control of Ministry Information Industry (MII) through a 20.42% stake held by China National Computer Software & Service Company Ltd. (CNSS). Chinasoft develops IT solutions for government controlled industries and SOE entities as well as provides software development / business process outsourcing services to renowned multi-national corporations (MNCs) such as Microsoft, IBM and NEC. In 1H FY12/06, net profit surged 34.7% YoY to RMB24.5m while revenues contracted 18.2% YoY to RMB133.8m. The top line contraction was due to a shift in the company's business focus away from less profitable hardware solutions in its government related businesses. This resulted in a 45.3% YoY decline in solutions revenues to RMB74.5m, but a 25.5 pcp improvement in operating margins to 56.8%. Outsourcing revenues jumped 109.3% YoY to RMB47.0m.

Microsoft and IFC on board. In January 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 US\$35m at maximum, 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 (5cents/share) on a quarterly basis. The deal provides Chinasoft with additional financial resources and support from high profile investors, who are able to help the company develop its outsourcing business and penetrate the overseas market.

Niche market in solutions segment. Chinasoft's strategy is to target the government and SOEs for its solutions segment. The company's self developed ResourceOne middleware application is 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. The strategy enables it to be partially buffered from the more cut-throat price competitive segments such as telecommunications and finance. Chinasoft adopts a top-down strategy whereby it gains approval of its self-developed solutions at the bureau level and then deploys the approved platform throughout the vertically integrated industry chain under the bureau or the governing authority's mandate. This minimizes the marketing and selling expenses after the initial development phase and allows the company to maintain its gross margins as the solution is migrated down the industry chain. During 1H FY12/06, the company commenced Phase 3 of the "Tobacco Production and Operation Decision System". The project involves the deployment of the centralized data collection platform to up to 350 commercial firms, 318 warehouses and 27 provincial commercial enterprises. In addition, the company expanded its Phase 1 e-Audit solutions to the Audit Bureaus of Sichuan, Hunan Provinces and Changning and Hongkou districts in Shanghai Province amongst others. Chinasoft plans to introduce its solutions platform to the pharmaceutical industry in FY12/07.

Outsourcing is the new growth driver. 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, IBM, Motorola (China) and Huawei. According to IDC, China's software offshore outsourcing market grew 55.6% YoY to US\$930m in 2005 and the firm projected this industry to increase at a CAGR of 41.2% between 2005-2010. At present, Japan remains the primary market for domestic vendors, accounting for 60.1% of offshore revenues. North America and European combined are second at only 20.4%. IDC predicted that North America/Europe will be the fastest growing region over this 5-year period with a CAGR of 44.7%. With Chinasoft's established presence and focus in this region, the company is in a solid position to capture this emerging opportunity.

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China can differentiate from India. Though China still lags behind India in terms of outsourcing scale and quality, it has a competitive niche that India cannot replicate, namely China's lucrative domestic market, to which many Western clients want to introduce their IT products. Chinese software outsourcing vendors can offer localization, testing services, while leveraging their familiarity of the local market. Note that many MNCs already own sizeable manufacturing bases on the Mainland, translating into a huge demand for back office and data entry support at the door step of China's IT industry.

Accelerating outsourcing growth through acquisitions. Chinasoft has been making strategic acquisitions to further accelerate its outsourcing sales growth. 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 it rounds out the company's outsourcing service profile and broadens its customer base. The company has made three acquisitions this financial year to date, but the management has hinted that the buying spree has not yet ended. We predict that the company's next acquisition will likely be a BPO company given that the other acquisitions so far have been mainly focused on ADM/EAS.

Table 1: Chinasoft's acquisitions in 2006

Company	% Stake	Consideration	Valuation	Description of operations
Cyber Resource	Increase 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%	Undisclosed	n/a	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.

Source: Company data

Chinasoft is the preferred partner for MNCs. Chinasoft's government and SOE experience has allowed the IT service provider to accumulate an in-depth understanding of IT related regulatory and procedures in key government industries such as tobacco, petroleum etc. We believe that Chinasoft's strong association and appreciation of processes in these sectors will make the IT services provider an attractive alliance candidate for MNCs, as they strive to gain a foothold in these markets which are traditionally difficult to penetrate. In our view, this is a key reason for Microsoft's strategic investment in the company. Other IT giants including Computer Associates and IBM have already formed alliances to bundle their software and hardware products into Chinasoft's solutions.

Preliminary profit forecast. We forecast profit to reach RMB64.1m (fully diluted EPS: RMB6.40 cents) for FY12/06F, up 35.0% YoY after excluding one-off provisions. Turnover is expected to drop 7.5% to RMB353.6m mainly due to a 42.4% YoY decline in solutions revenues as the company completes its strategic alignment to more profitable software business. Outsourcing revenue is expected to surge 170% YoY to RMB143.2m, accounting for 40.5% of total turnover. We project FY12/07F turnover and net profit to jump 41.2% and 57.5% YoY to RMB499.5m and RMB100.9m (fully diluted EPS: RMB8.97cents) respectively.

Valuation. Chinasoft is currently trading at 17.2x FY12/06F and 13.9x FY12/07F P/E compared to an industry average of 27.4x and 21.1x based on consensus estimates.

Corporate governance issues. Chinasoft was listed on the GEM Board in June 2003. The company's substantial shareholders include CNSS (20.42%), Far East Technology (17.44%), Microsoft (9.98%) and IFC (9.98%). Dr Chen Yuhong, Managing Director, has over 18 years' experience in software development and was formally the Vice President of CNSS. The company has been using Deloitte as its financial auditor since its IPO and has not raised further funds from the equity market since then. Management indicated to apply for a Main Board listing by early 2007. The company paid out 21.4% of earnings in FY12/04 and 47.9% in FY12/05, but has pledged to maintain a payout ratio of 30% going forward.

Table 2: Valuation comparisons

Company Name	Ticker	Yr End	Mkt Cap (US\$m)	Price	Cur Yr P/E (x)	Next Yr P/E (x)
Tata Consultancy	TCS IN	Mar	20,017	INR950.00	24.2	19.7
Wipro	WPRO IN	Mar	15,648	INR507.35	26.8	21.3
Infosys	INFO IN	Mar	20,039	INR1,680.95	26.4	21.0
Shenyang Neusoft	600718 CH	Dec	396	RMB11.41	37.0	27.2
UFIDA	600588 CH	Dec	572	RMB20.64	30.0	23.2
Sinocom	299 HK	Dec	299	HK\$2.13	20.1	13.9
Average					27.4	21.1
Chinasoft	8216 HK	Dec	102.7	HK\$1.06	17.2	13.9

Source: Bloomberg

Table 3: P&L

Year to Dec (RMBm)	2003A	2004A	2005A
Turnover			
Solutions	114.9	240.8	301.1
Outsourcing	45.2	34.3	53.0
Consulting & Training Services	2.6	6.3	7.6
Sales of Standalone Software	3.3	12.5	20.6
	166.1	293.9	382.3
Cost of sales	(117.1)	(212.3)	(264.3)
Gross profit	49.0	81.6	118.0
Other operating income	0.8	0.8	4.6
Distribution costs	(5.9)	(9.9)	(18.9)
Administrative expenses	(12.3)	(29.6)	(44.6)
Amortization of intangible assets	(0.2)	(0.7)	(3.0)
Amortization of goodwill	-	(1.0)	-
Allowance for doubtful debts	-	(3.8)	(9.3)
Operating profit	31.5	37.5	46.9
Finance costs	(0.5)	(0.1)	(0.0)
Share of profits and losses of jointly controlled entities	-	-	-
Share of profits of an associated	-	1.2	1.8
Profit before taxation	31.0	38.7	48.7
Taxation	(2.7)	(3.9)	(5.7)
Profit after taxation	28.2	34.8	43.0
Minority interests	(4.1)	(3.0)	(3.3)
Profit attributable to shareholders	24.1	31.8	39.7
% chg	24.3	31.7	24.8
Dividend	-	(6.8)	(19.0)

Source: Company data