

**Ready for the 4Q spurt****China Software****Chinasoft International (8216 HK, HK\$1.34)****Not Rated**

**3Q results slightly ahead of expectations.** Chinasoft's 3Q FY12/06 results were ahead of expectations. Turnover rose 1.3% YoY to RMB92.5m, while gross profit surged 81.8% YoY to RMB46.9m. Net profit came in at RMB15.5m, up 46.9% YoY. Similar to the previous quarters in FY12/06, the flat YoY growth was the result of the company's focus on software solution development, moving away from hardware implementation. This led to lower revenues, but a substantial increase in gross margin. For the quarter, gross margin jumped 22.4 pcp to 50.7%.

**Organic and acquisition fueled growth.** The gains were driven by acquisitive growth in IT outsourcing and organic growth in solutions. IT outsourcing revenue was up 78.5% QoQ and 181.8% YoY to RMB41.3m, benefiting from the maiden consolidation of associate turned 76%-owned subsidiary Cyber Resources. The segment accounted for 44.6% of overall turnover, compared to 32.7% at the end of 2Q. Meanwhile, solutions revenues rose 15.3% QoQ and down 31.4% YoY to RMB46.3m as the company continued to roll out its self-developed tracking and management solution for the tobacco industry.

**Government industries driving solutions.** During the quarter, the company commenced the development of a management and information system for the Tibetan tobacco administration. Once the project is completed, the solution will be deployed across all tobacco companies within the autonomous region. Chinasoft also won similar contracts with Yunan tobacco administration as well as Pagoda Group. In addition, Phase 3 of the company's tobacco solution remains on track for deployment from early next year. It began promotion of the "production and operation decision making system" across the country and set up testing centres in six provinces and cities. The solution aims to improve transparency along the tobacco value chain by tagging individual items at the "carton" level and linking factory production, delivery and POS sell through via designated call centres. The Phase 3 tobacco solution, together with the introduction of its e-audit solution is expected to drive Chinasoft's solution segment, which we expect to grow around 25-30% YoY in FY12/07.

**Rapid expansion in IT outsourcing continues.** Chinasoft has now ramped up its headcount in its IT outsourcing business from 520 at the end of last year to 1,353 at the end of 3Q FY12/06. The segment should sustain its rapid expansion pace with newly acquired companies Powerise and Opportune Technology expected to contribute in 4Q FY12/06. The company entered into a master services agreement with its strategic investor Microsoft in early October this year. Under the terms of the agreement, Chinasoft is expected to provide outsourcing services to Microsoft with an annual cap of HK\$73.3m, HK\$95.2m, HK\$124.0m, HK\$161.5m and HK\$174.7m between 2007-2011. The IT segment will remain under the market spotlight as we still expect Chinasoft to announce at least another acquisition before the year-end.

**Ready for the 4Q spurt.** Chinasoft appears to be well positioned to capture the traditionally strong 4Q in the IT industry. We project solutions revenue to jump around 30% QoQ to RMB58.5m, while IT outsourcing revenues is expected to hit RMB54.3m with contribution from newly acquired subsidiaries. However, we have revised down our full year net profit forecast to RMB61.3m (fully diluted EPS: RMB5.87 cents) for FY12/06F and RMB95.9m (fully diluted EPS: RMB8.06 cents) for FY12/07F to factor in likely year-end bonuses to the management.

**Valuation.** Chinasoft is currently trading at 23.7x FY12/06F P/E and 15.5x FY12/07F P/E compared to an industry average of 28.1x and 20.7x based on consensus estimates.

**Table 1: 3Q results**

3 months to September	Turnover (RMBm)	Gross profit (RMBm)	Gross margin (%)	Operating profit (RMBm)	Tax rate (%)	Net profit (RMBm)	Basic EPS (RMB)
3Q06	92.5	46.9	50.7	19.3	14.3	15.5	0.0204
3Q05	91.3	25.8	28.3	13.2	5.4	10.5	0.0144
YoY (%)	1.3	81.8	22.4	46.1	n/a	46.9	41.7

Source: Company data

**Table 2: Peer valuation comparisons**

Company Name	Stock Code	Yr End	Mkt Cap (US\$m)	Price	Cur Yr P/E (x)	Next Yr P/E (x)
Tata Consultancy	TCS IN	Mar	22,542	INR1,059.40	25.6	20.3
Wipro	WPRO IN	Mar	16,488	INR531.55	27.6	21.8
Infosys	INFO IN	Mar	25,344	INR2,070.55	31.5	24.4
Shenyang Neusoft	600718 CH	Dec	533	RMB15.62	29.9	14.9
UFIDA	600588 CH	Dec	631	RMB22.57	32.9	27.5
Sinocom	299 HK	Dec	232	HK\$1.65	21.1	15.0
<b>Average</b>					<b>28.1</b>	<b>20.7</b>
Chinasoft	8216 HK	Dec	130	HK\$1.34	23.7	15.5

Source: Bloomberg

**Table 3: P&L**

Year to Dec (RMBm)	2003	2004	2005
<b>Turnover</b>			
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
	<b>166.1</b>	<b>293.9</b>	<b>382.3</b>
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
<b>Profit before taxation</b>	<b>31.0</b>	<b>38.7</b>	<b>48.7</b>
Taxation	(2.7)	(3.9)	(5.7)
<b>Profit after taxation</b>	<b>28.2</b>	<b>34.8</b>	<b>43.0</b>
Minority interests	(4.1)	(3.0)	(3.3)
<b>Profit attributable to shareholders</b>	<b>24.1</b>	<b>31.8</b>	<b>39.7</b>
% chg	24.3	31.7	24.8
Dividend	-	(6.8)	(19.0)

Source: Company data