

## Chinasoft: IT outsourcing powerhouse from China

**Recommendation: BUY (unchanged)**

**China Technology**

Price	HK\$1.90	Year to	Net profit*	EPS*	EPS	P/E	P/B	EV/EBITDA	Yield	ROE	ROCE	N. Gear.
Target price	HK\$2.95 (+55%)	Dec	RMBm	RMB	Δ %	x	x	x	%	%	%	%
12 mth range	HK\$1.00-2.21	05A	39.7	0.054	15.8	33.1	4.6	25.2	0.6	16.1	15.6	Cash
Market cap.	US\$197.43m	06A	44.0	0.059	5.5	31.3	6.5	15.5	1.3	17.3	16.2	Cash
Daily t/o, 3 mth	US\$0.17m	07F	92.6	0.104	76.8	17.7	2.5	7.8	1.7	21.4	20.3	Cash
Free float %	42.7%	08F	160.8	0.123	18.3	15.0	3.2	5.0	2.0	22.7	21.9	Cash
Ticker	8216.HK/8216 HK	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:

- Sustaining growth momentum from the first quarter, 2Q FY12/07A net profit grew 25.5% YoY to RMB17.7m (excluding revaluation loss from its convertible preference shares with Microsoft/IFC).
- Bottom line was driven by strong revenue gains in its 2 key segments of solutions and IT outsourcing.
- HGR acquisition expected to close by end of Aug 2007, which would further add value and boost top and bottom lines for the company
- Chinasoft continues to benefit from the fast growing IT outsourcing industry in China. We maintain our BUY call with a target price of HK\$2.95, representing 24.0x FY12/08F P/E on a fully diluted basis.

**Strong 2Q FY12/07A results, in line with our expectation:** Chinasoft sustained its 1Q growth momentum by delivering another strong set of results in 2Q. In a seasonally stronger 2Q FY12/07A, turnover jumped 193.9% YoY and 74.6% QoQ to RMB207.8m. Excluding a non-cash fair value loss of RMB18.1m from its convertible preference shares with Microsoft and IFC, the company's net profit of RMB17.7m signaled an increase of 25.5% YoY and 47.8% QoQ. Gross margin dropped to 33.3% from 46.5% a year ago as increased sales of lower margin hardware dragged down the number. The results were in line with our expectations.

**Table 1: 2Q FY12/07A results (YoY comparison)**

Three months to June	Turnover (RMBm)	Gross profit (RMBm)	Gross margin (%)	Adjusted profit* (RMBm)	Pre-tax profit* (RMBm)	Tax rate (%)	Adjusted Net profit* (RMBm)	Adjusted EPS* (RMB)	DPS (RMB)
2Q FY06	70.7	32.9	46.5	16.8	16.6	14.0	0.014	0.019	
2Q FY07	207.8	69.3	33.3	24.6	17.0	17.7	0.020	0.001	
YoY (%)	193.9	110.6		46.4		25.5		35.7	

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

Source: Company data

**Table 2: 2Q FY12/07A results (QoQ comparison)**

Three months to June	Turnover (RMBm)	Gross profit (RMBm)	Gross margin (%)	Adjusted profit* (RMBm)	Pre-tax profit* (RMBm)	Tax rate (%)	Adjusted Net profit* (RMBm)	Adjusted EPS* (RMB)	DPS (RMB)
1Q FY07	119.0	46.8	39.3	14.8	15.2	12.0	0.016	-	
2Q FY07	207.8	69.3	33.3	24.6	17.0	17.7	0.019	0.001	
QoQ (%)	74.6	48.1		66.2		47.5		18.8	

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

Source: Company data

**Both solution and IT outsourcing are the growth drivers.** The company's growth was driven by both

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segments of solutions and IT outsourcing. For 2Q FY12/07A, solutions surged 271.6% to RMB149.0m and IT outsourcing 115.6% to RMB49.8m.

**Sales of software solutions surged 246.2% after excluding hardware.** Similar to 1Q FY12/07A, a portion of the growth in the solutions side came was due to a marked increase in sales of hardware as part of the solutions. However, excluding the hardware component, solutions was still up 246.2%. For the period, Chinasoft continued its partnership with the State Tobacco Monopoly Administration to implement both bar code and RFID projects of various sorts in Guangdong, Liaoning, Anhui and Hubei. It was also successful in entering into contracts for both e-audit and e-insurance sectors.

**Table 3: Revenue breakdown (2Q FY12/07A)**

Segment	Revenue (RMBm)	% of overall revenue	YoY chg (%)	QoQ chg (%)
IT solutions	149.0	71.7	271.5	84.6
IT outsourcing	49.8	24.0	115.4	48.6
IT consulting and training services	3.9	1.9	38.4	(2.8)
Standalone software products	5.0	2.4	7.9	554.9
Total	207.8	100.0	193.9	74.6

Source: Company data

**Growth in IT outsourcing accelerating.** The IT outsourcing segment performed similarly well. On a year on year basis, Chinasoft added some 30% more staff, helped by its acquisition of Opportune and Powerise in 2H FY12/06A. For the quarter, RMB3.7m revenue was derived from Japanese customers, RMB13.9m were derived from European/American customers, with the remaining RMB32.2 m from other regions.

**Administration expenses grew sharply, but in line with cost structure.** Administration expenses increased a marked 211.5% YoY to RMB35.0m, which is understandable given the significant increase in operating scale from a year ago. As a percentage of revenues, administration expense rose 0.9 pcp YoY to 16.8%. A portion of the increase in administration expenses would be fees related to its Hinge Global Resources (HGR) acquisition.

**Expect a stronger 3Q & 4Q performance, net profit estimates unchanged.** We expect that Chinasoft would close its acquisition of HGR sometime by the end of Aug 2007, which would provide a further boost to Chinasoft's top and bottom lines. We have left our adjusted net profit (excluding revaluation gains/losses from its convertible preference shares) unchanged at RMB92.6m for FY12/07F and RMB160.8m for FY12/08F.

**Re-iterate BUY call, target price HK\$2.95.** Chinasoft sustained its 1Q momentum fundamentals and the company continues to benefit from the fast growing IT outsourcing industry in China. We re-iterate our BUY call with a target price of HK\$2.95, representing 24.0x FY12/08F P/E (fully diluted). The counter is undemanding, currently trading at 15.5x FY12/08F P/E.

Table 4: P&amp;L

Year to Dec (RMBm)	05A	06A	07F	08F	09F
<b>Turnover</b>					
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
	<b>382.3</b>	<b>355.2</b>	<b>778.3</b>	<b>1,166.6</b>	<b>1,430.2</b>
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	-	-
<b>Adjusted profit before taxation *</b>	<b>48.7</b>	<b>58.6</b>	<b>110.3</b>	<b>189.4</b>	<b>232.6</b>
Taxation	(5.7)	(11.9)	(14.9)	(23.7)	(29.1)
<b>Adjusted profit after taxation *</b>	<b>43.0</b>	<b>46.7</b>	<b>95.4</b>	<b>165.8</b>	<b>203.5</b>
Minority interests	(3.3)	(2.7)	(2.9)	(5.0)	(6.1)
<b>Adjusted profit attributable to shareholders *</b>	<b>39.7</b>	<b>44.0</b>	<b>92.6</b>	<b>160.8</b>	<b>197.4</b>
% 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)	-	-
<b>Profit attributable to shareholders</b>	<b>39.7</b>	<b>(66.9)</b>	<b>9.6</b>	<b>160.8</b>	<b>197.4</b>
% 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

P & L (RMBm)	05A	06A	07F	08F	09F	Cash Flow (RMBm)	05A	06A	07F	08F	09F
<b>Year to Dec</b>						<b>Year to Dec</b>					
<b>Turnover</b>	<b>382.3</b>	<b>355.2</b>	<b>778.2</b>	<b>1,166.6</b>	<b>1,430.2</b>	EBIT	56.2	68.9	120.5	201.5	245.7
% chg	30.1	(7.1)	119.1	49.9	22.6	Depre./amort.	(6.6)	(15.8)	(49.4)	(55.0)	(58.9)
Gross profit	118.0	168.9	341.7	477.5	573.2	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)
EBITDA	62.8	84.7	169.9	256.5	304.6	Others	17.4	44.1	78.2	75.7	74.0
Depre./amort.	(6.6)	(15.8)	(49.4)	(55.0)	(58.9)	<b>Gross cashflow</b>	<b>63.3</b>	<b>77.0</b>	<b>122.8</b>	<b>185.2</b>	<b>217.3</b>
EBIT	56.2	68.9	120.5	201.5	245.7	Chgs. in working cap.	(19.0)	(69.5)	(66.1)	(72.7)	(52.5)
Net int. income/(exp.)	(0.0)	(10.8)	(8.5)	(8.6)	(8.6)	<b>Operating cashflow</b>	<b>44.3</b>	<b>7.4</b>	<b>56.7</b>	<b>112.5</b>	<b>164.8</b>
Exceptionals	(9.3)	(2.0)	(2.5)	(3.5)	(4.5)	Capex	(14.7)	(49.9)	(12.2)	(29.9)	(24.2)
Associates	1.8	2.5	0.9	-	-	<b>Free cashflow</b>	<b>29.6</b>	<b>(42.5)</b>	<b>44.5</b>	<b>82.6</b>	<b>140.6</b>
Jointly-controlled entit.	-	-	-	-	-	Dividends paid	(7.9)	(18.2)	(27.8)	(48.2)	(59.2)
<b>Adjusted pre-tax profit</b>	<b>48.7</b>	<b>58.6</b>	<b>110.3</b>	<b>189.4</b>	<b>232.6</b>	Net distribution to MI	(3.3)	(2.7)	(2.9)	(5.0)	(6.1)
Tax	(5.7)	(11.9)	(14.9)	(23.7)	(29.1)	Investments	na	(80.6)	(35.0)	(7.8)	-
Minority interests	(3.3)	(2.7)	(2.9)	(5.0)	(6.1)	Disposals	-	0.1	0.1	0.1	0.2
<b>Adjusted net profit</b>	<b>39.7</b>	<b>44.0</b>	<b>92.6</b>	<b>160.8</b>	<b>197.4</b>	New shares					
% chg	24.8	10.9	110.5	73.7	22.8	Others	na	182.4	12.8	23.9	24.0
Dividends	(7.4)	(18.3)	(27.8)	(48.2)	(59.2)	<b>Net cashflow</b>	<b>28.2</b>	<b>38.4</b>	<b>(8.2)</b>	<b>45.6</b>	<b>99.5</b>
Retained earnings	32.3	25.7	64.8	112.6	138.2	Net (debt)/cash - Beg.	74.0	100.1	133.6	118.7	157.7
EPS (RMB) - Basic	0.056	0.059	0.104	0.123	0.151	Net (debt)/cash - End.	100.1	133.6	118.7	157.7	265.1
EPS (RMB) - F.D.	0.054	0.059	0.104	0.123	0.151	<b>Interim Results (RMBm)</b>	<b>05A</b>	<b>06A</b>			
DPS (RMB)	0.010	0.024	0.031	0.037	0.045	<b>Six months to Jun</b>					
No. sh.s o/s (m) - W.A.	661.3	713.5	749.8	892.8	1,311.1	<b>Turnover</b>	<b>163.5</b>	<b>133.8</b>			
No. sh.s o/s (m) - Y.E.	739.4	732.4	758.8	1,224.1	1,311.1	% chg	na	(18.2)			
No. sh.s o/s (m) - F.D.	667.9	730.7	749.8	892.8	1,311.1	Profit from operations	19.0	28.0			
						Interest expenses	(0.0)	(0.0)			
<b>Margins (%)</b>						Associates	0.6	1.3			
Gross	30.9	47.5	43.9	40.9	40.1	Jointly-controlled entit.					
EBITDA	16.4	23.8	21.8	22.0	21.3	<b>Pre-tax profit</b>	<b>19.5</b>	<b>29.3</b>			
EBIT	14.7	19.4	15.5	17.3	17.2	Tax	(1.3)	(4.7)			
Pre-tax	12.7	16.5	14.2	16.2	16.3	Minority interests	-	0.0			
Net	10.4	12.4	11.9	13.8	13.8	<b>Net profit</b>	<b>18.2</b>	<b>24.5</b>			
						% chg	na	34.7			
Adjusted numbers exclude the effect of loss arising from change in fair value of redeemable convertible preferred shares.						EPS (RMB) - Basic	0.026	0.033			
						DPS (RMB)	0.011	0.026			
<b>Balance Sheet (RMBm)</b>	<b>05A</b>	<b>06A</b>	<b>07F</b>	<b>08F</b>	<b>09F</b>	<b>Shareholding Structure</b>					
<b>Year to Dec</b>									<b>Shares o/s (m)</b>	<b>%</b>	
Fixed assets	23.3	42.3	66.6	83.3	98.3	CS&S			199.0	24.6	
Intangible assets	18.0	48.9	57.4	70.5	79.7	Far East			130.2	16.1	
Other LT assets	87.7	153.8	505.1	472.4	445.9	ABN AMRO Holding N.V.			48.4	6.0	
Cash	100.1	133.6	118.7	157.7	265.1	Zhou Qi			46.9	5.8	
Accounts receivable	182.1	234.0	320.4	476.5	503.1	Public			346.1	42.7	
Other receivables	-	-	-	-	-	<b>Total</b>			<b>810.5</b>	<b>100.0</b>	
Inventories	22.7	34.1	61.6	85.3	102.5						
Due from related co.s	1.8	-	-	-	-	<b>Background</b>					
Other current assets	3.1	14.5	3.0	4.0	1.0	Chinasoft is one of China's leading IT solution and outsourcing companies.					
<b>Total assets</b>	<b>438.8</b>	<b>661.2</b>	<b>1,132.7</b>	<b>1,349.8</b>	<b>1,495.7</b>	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.					
Accounts payable	(98.3)	(107.7)	(155.5)	(262.6)	(254.0)						
Other payable	-	-	-	-	-	<b>Key Ratios</b>	<b>05A</b>	<b>06A</b>	<b>07F</b>	<b>08F</b>	<b>09F</b>
Tax payable	(2.8)	(4.7)	(3.0)	(2.0)	(3.0)	Net gearing (%)	Cash	Cash	Cash	Cash	Cash
Due to related co.s	-	(0.5)	-	-	-	Net ROE (%)	16.1	17.3	21.4	22.7	23.7
ST debts	-	-	-	-	-	EBIT ROCE (%)	22.1	25.4	26.5	27.5	28.5
Other current liab.	(26.8)	(43.6)	(26.7)	(23.0)	(32.0)	Dividend payout (%)	18.6	41.6	30.0	30.0	30.0
LT debts	-	-	-	-	-	Effective tax rate (%)	11.7	20.3	13.5	12.5	12.5
Other LT liabilities	(1.8)	(271.1)	(271.0)	(272.7)	(273.8)	Net interest coverage (x)	na	6.4	14.1	23.5	28.7
<b>Total liabilities</b>	<b>(129.7)</b>	<b>(427.6)</b>	<b>(456.1)</b>	<b>(560.3)</b>	<b>(562.8)</b>	A/R turnover (days)	144.3	213.8	130.0	125.0	125.0
Share capital	38.3	40.2	55.0	55.0	55.0	A/P turnover (days)	121.8	201.7	110.0	111.0	110.0
Reserves	256.2	172.7	595.7	708.3	846.5	Stock turnover (days)	39.5	55.6	40.0	39.0	40.0
<b>Shareholders' funds</b>	<b>294.5</b>	<b>212.8</b>	<b>650.7</b>	<b>763.3</b>	<b>901.5</b>						
Minority interest	14.0	20.8	25.9	26.2	31.5						
<b>Total</b>	<b>308.5</b>	<b>233.7</b>	<b>676.6</b>	<b>789.5</b>	<b>932.9</b>						
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						

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