

## Kingsoft (3888 HK)

**Buy** (maintained)

Target price: HK\$21.10



**Ryan Zhu, CPA**

SFC CE No. BDK820

[zhuran@gfgroup.com.hk](mailto:zhuran@gfgroup.com.hk)

+86-0755-88263160

**Joseph Ho, CFA**

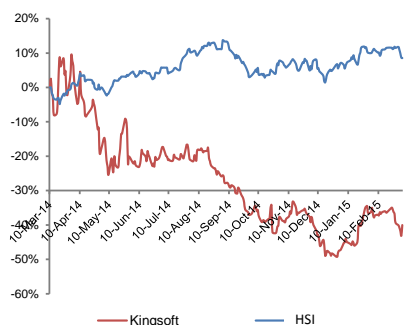
SFC CE No. AFP308

[josephho@gfgroup.com.hk](mailto:josephho@gfgroup.com.hk)

+852-37191030

GF Securities (Hong Kong) Brokerage Limited  
29-30/F, Li Po Chun Chambers  
189 Des Voeux Road Central  
Hong Kong

### Stock performance



Source: Bloomberg

### Key data

Mar 6 close (HK\$)	17.60
Shares in issue (m)	1,181.1
Major shareholder	Lei Jun 29.9%
Market cap (HK\$ bn)	20.8
3M avg. vol. (m)	6.97
52W high/low (HK\$)	32.30 / 14.88

Source: Bloomberg

Positive on all-in cloud strategy; maintain Buy

**All-in cloud strategy** Kingsoft announced in Dec that it would adopt an all-in cloud strategy, with US\$1bn set to be invested in cloud services over the next 3-5 years. The company acquired an 11.6% stake (representing 19.9% of the voting power) in 21Vianet (a US-listed leading Chinese IDC service provider) in Nov 2014 for US\$172m. Separately, according to its cooperation agreement with Xiaomi, the annual cap on cloud revenue from Xiaomi was set at Rmb95m, Rmb450m and Rmb1,500m for 2014/15/16 respectively. Xiaomi agreed that 70% of its cloud storage and cloud computing services would be procured from KingSoft. Xiaomi's demand for cloud services increased rapidly at a monthly compound growth rate of 28% in 9M14. Meanwhile, the company also entered into a cooperation with China Telecom to provide cloud-based solutions in Feb 2015. In 9M14, its cloud business revenue grew at a strong monthly compound growth rate of 23%. As the domestic cloud service market is in its initial rapid-growth stage, a quick and large-scale investment should help the company to win out in this area, given excellent management execution, its partnership with Xiaomi and strong cash support. We expect revenue contribution from cloud services to rise to 14% in FY16E, from 3% in FY14E.

**Relationship with Xiaomi** Xiaomi, a leading Chinese smartphone maker owned by Lei Jun (Kingsoft's major shareholder and chairman), acquired a 2.98% stake in Kingsoft from Tencent in Jan 2015. Lei Jun increased his voting power in Kingsoft to 29.9% just after the decision was taken to go for an all-in cloud strategy, demonstrating his strong confidence in Kingsoft's cloud business. Xiaomi is also a strategic shareholder in almost all of Kingsoft's major business, Cheetah Mobile (5+% stake), online gaming business (4.7% stake in Westhouse Studio), and Kingsoft cloud (10+% stake). It is also a co-investor with Kingsoft in 21Vianet (3.4% stake and 10% of the voting power).

**Cheetah Mobile to sustain strong momentum** Cheetah Mobile's monthly active user base has risen rapidly from 46m in 1Q13 to 341m in 3Q14 with average QoQ growth of 40% thanks to the increasing popularity of its mobile applications, such as Clean Master, Battery Doctor and CM Security. Cheetah Mobile has entered a cooperation with Samsung this month to pre-install its star app Clean Master on Samsung's new flagship Galaxy S6 and Galaxy S6 Edge smartphones. We expect Cheetah Mobile to sustain strong momentum by further enlarging its mobile user base and improving its monetization efficiency.

**Maintain Buy and raise TP to HK\$21.10** We are positive on Kingsoft's all-in cloud strategy as we see long-term growth opportunities in the cloud services market; however, increased investment may lead to operating margin pressure during the next 4-6 quarters. We maintain our Buy rating and slightly raise our sum-of-the-parts target price from HK\$20.50 to HK\$21.10 on an increased valuation for its cloud business, partly offset by a lower valuation for its gaming business amid uncertainty in new mobile games. Our target price implies 22x FY15E P/E. The company will release its FY14 results on Mar 20. We forecast recurring net profit will decline 4% to Rmb703m in FY14, broadly in line with consensus of Rmb701m.

**Key risks** Lower-than-expected performance for new mobile games; slowdown in mobile user base growth; longer-than-expected investment cycle for its cloud business.

### Stock valuation

	Turnover (Rmb m)	YoY (%)	* Net profit (Rmb m)	YoY (%)	*Diluted EPS (Rmb cents)	YoY (%)	P/E	P/B	ROE (%)	Dividend yield (%)	Net gearing (%)
2012	1,411	38	481	41	41	41	34.4	6.6	17.2	0.6	cash
2013	2,174	54	732	52	60	45	23.6	5.1	19.8	0.7	cash
2014E	3,235	49	703	-4	56	-8	25.6	3.4	12.9	0.6	cash
2015E	4,842	50	976	39	77	39	18.4	2.9	14.2	0.8	cash
2016E	6,741	39	1,483	52	117	52	12.1	2.4	19.2	0.8	cash

Sources: Company data, GF Securities (HK)

Note: \* excluding share-based cost and one-off disposal gains

Figure 1: Quarterly revenue and adjusted operating margin

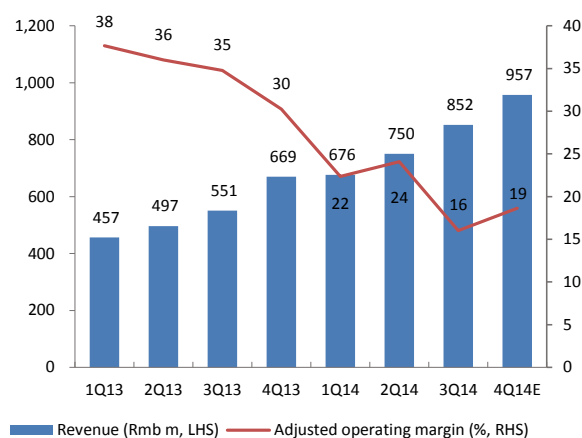
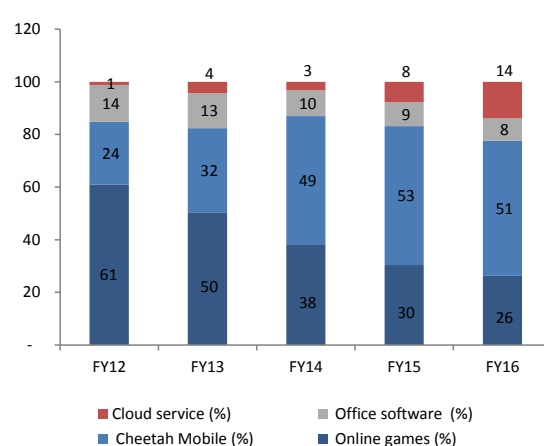


Figure 2: Revenue breakdown during FY12-16E



Sources: Company data, GF Securities (HK)

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Figure 3: Revenue and adjusted operating margin forecasts during FY11-16E

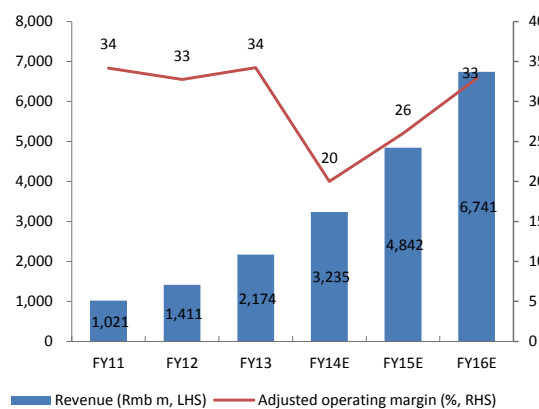
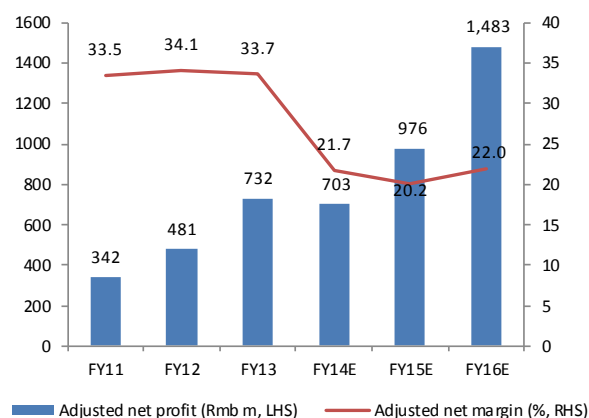


Figure 4: Adjusted net profit and net margin forecasts during FY11-16E



Sources: Company data, GF Securities (HK)

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Figure 5: Sum-of-the-parts valuation table

Rmb m	Ownership (%)	FY15 revenue	FY15 adjusted net profit	P/E (x)	P/S (x)	Valuation	Value attributable to KingSoft	Per share value (HK\$)	Percentage (%)
Online gaming	76.0%	1,473	629	10		6,294	4,783	5.0	24
Cheetah mobile	48.0%	2,554	500	30		15,000	7,200	7.5	36
WPS office	70.0%	441	176	21		3,705	2,594	2.7	13
Kingsoft cloud	64.0%	375	(185)		6	2,248	1,438	1.5	7
21Vianet	11.6%					7,212	837	0.9	4
Cash value*	100.0%					3,281	3,281	3.4	16
<b>Total</b>							<b>20,133</b>	<b>21.1</b>	<b>100</b>
<b>Shares in issue (m)</b>							<b>1,185</b>		

Sources: Company data, GF Securities (HK)

Note: \* cash value is based on estimated net cash position as end-2014

Figure 6: Financial statements

Income Statement						Balance Sheet					
Year end Dec (Rmb m)	2012	2013	2014E	2015E	2016E	Year end Dec (Rmb m)	2012	2013	2014E	2015E	2016E
Online game	861	1,096	1,228	1,473	1,772	Cash/ST deposit	620	2,677	2,084	4,206	6,257
Cheetah Mobile	337	694	1,586	2,554	3,460	Time deposits of over 3 months	1,815	1,824	4,093	4,093	4,093
Office software and others	214	383	422	815	1,509	Account receivables	130	185	235	351	489
<b>Turnover</b>	<b>1,411</b>	<b>2,174</b>	<b>3,235</b>	<b>4,842</b>	<b>6,741</b>	Inventory	17	4	18	30	44
YoY (%)	38	54	49	50	39	Other Current Assets	482	386	407	407	407
Cost of sales	-187	-298	-526	-872	-1,281	<b>Total current assets</b>	<b>3,065</b>	<b>5,075</b>	<b>6,836</b>	<b>9,087</b>	<b>11,290</b>
<b>Gross profit</b>	<b>1,224</b>	<b>1,876</b>	<b>2,710</b>	<b>3,970</b>	<b>5,460</b>	Property, plant & equipment	371	385	428	459	478
Other income and gains	29	45	38	50	50	Intangible assets	53	60	165	199	218
Selling&marketing exp.	-234	-382	-802	-1,012	-1,308	Other LT Assets	152	284	2,486	1,420	1,420
Admin exp.	-148	-192	-289	-363	-472	<b>Total non-current assets</b>	<b>576</b>	<b>729</b>	<b>3,079</b>	<b>2,078</b>	<b>2,116</b>
R&D costs	-385	-596	-979	-1,356	-1,483	<b>Total Assets</b>	<b>3,641</b>	<b>5,804</b>	<b>9,916</b>	<b>11,165</b>	<b>13,406</b>
Other expenses	-71	-68	-239	-181	-131	ST Debt	414	16	16	16	16
<b>Operating profit</b>	<b>414</b>	<b>683</b>	<b>439</b>	<b>1,109</b>	<b>2,117</b>	Trade payables	23	32	49	81	119
Finance income	98	129	234	315	377	Other Current Liabilities	496	740	1,017	1,113	1,265
Finance costs	-9	-24	-82	-116	-116	<b>Total current liabilities</b>	<b>933</b>	<b>789</b>	<b>1,082</b>	<b>1,210</b>	<b>1,401</b>
Others	25	37	296	90	90	Long term debt	0	1,116	2,880	2,880	2,880
<b>Pre-tax income</b>	<b>528</b>	<b>825</b>	<b>887</b>	<b>1,398</b>	<b>2,468</b>	Other non-current liabilities	34	69	69	69	69
Taxation	-61	-71	-101	-173	-287	<b>Total non-current liabilities</b>	<b>34</b>	<b>1,185</b>	<b>2,949</b>	<b>2,949</b>	<b>2,949</b>
MI	-34	-83	-96	-355	-763	<b>Total liabilities</b>	<b>966</b>	<b>1,974</b>	<b>4,031</b>	<b>4,160</b>	<b>4,350</b>
<b>Net profit</b>	<b>433</b>	<b>671</b>	<b>690</b>	<b>869</b>	<b>1,418</b>	Minority Interests	160	450	546	901	1,664
YoY (%)	33	55	3	26	63	<b>Shareholders' Equity</b>	<b>2,515</b>	<b>3,380</b>	<b>5,338</b>	<b>6,104</b>	<b>7,391</b>
<b>Adjusted net profit</b>	<b>481</b>	<b>732</b>	<b>703</b>	<b>976</b>	<b>1,483</b>	<b>Total Equity &amp; liabilities</b>	<b>3,641</b>	<b>5,804</b>	<b>9,916</b>	<b>11,165</b>	<b>13,406</b>
YoY (%)	41	52	-4	39	52	<b>BPS (RMB)</b>	<b>2.2</b>	<b>2.8</b>	<b>4.2</b>	<b>4.8</b>	<b>5.8</b>
<b>Adjusted EPS(RMB cents)</b>	<b>41</b>	<b>60</b>	<b>56</b>	<b>77</b>	<b>117</b>	YoY (%)	19	28	52	14	21
YoY (%)	41	45	-8	39	52						

Cash Flow Statement						Financial Ratio					
Year end Dec (Rmb m)	2012	2013	2014E	2015E	2016E		2012	2013	2014E	2015E	2016E
Pretax profit	528	754	887	1,398	2,468	<b>Margins</b>					
Tax Paid	-61	-71	-101	-173	-287	Gross margin (%)	86.8	86.3	83.7	82.0	81.0
Depr/Amort	89	99	122	155	184	EBITDA margin (%)	35.5	35.9	17.3	26.1	34.1
Change in working capital	22	99	208	-0	38	Operating margin (%)	29.3	31.4	13.6	22.9	31.4
Others	-21	57	0	0	0	Net margin (%)	30.7	30.9	21.3	18.0	21.0
<b>Operational cash flow</b>	<b>556</b>	<b>938</b>	<b>1,116</b>	<b>1,380</b>	<b>2,403</b>	Adjusted net margin (%)	34.1	33.7	21.7	20.2	22.0
Capex	-66	-91	-270	-220	-220	<b>Returns and profitability</b>					
Assoc, MI, Invsmt	-1,074	124	-4,472	1,066	0	ROE (%)	17.2	19.8	12.9	14.2	19.2
<b>Investment cash flow</b>	<b>-1,140</b>	<b>33</b>	<b>-4,742</b>	<b>846</b>	<b>-220</b>	ROA (%)	11.9	11.6	7.0	7.8	10.6
Net Change in Debt	67	665	1,764	0	0	<b>Working capital</b>					
New Capital	59	582	1,379	0	0	Receivables (days)	27.3	26.5	26.5	26.5	26.5
Dividend	-93	-101	-111	-104	-130	Inventory (days)	19.8	12.6	12.6	12.6	12.6
Others	-23	-24	0	0	0	Payable (days)	38.7	34.0	34.0	34.0	34.0
<b>Financing cash flow</b>	<b>10</b>	<b>1,122</b>	<b>3,032</b>	<b>-104</b>	<b>-130</b>	<b>Financial health</b>					
FX and others	-6	-35	0	0	-2	Current ratio (x)	30.4	15.5	15.8	13.3	12.4
<b>Chg in Cash</b>	<b>-574</b>	<b>2,093</b>	<b>-594</b>	<b>2,122</b>	<b>2,053</b>	Net gearing (%)	cash	cash	cash	cash	cash
Beginning cash	1,199	620	2,677	2,084	4,206	<b>Others</b>					
<b>Ending cash</b>	<b>620</b>	<b>2,677</b>	<b>2,084</b>	<b>4,206</b>	<b>6,257</b>	Dividend payout ratio(%)	24.2	16.6	15.0	15.0	15.0
						Effective tax ratio(%)	10.6	8.0	11.2	11.2	11.2

Sources: Company data, GF Securities (HK)

## Rating definitions

Benchmark: Hong Kong Hang Seng Index  
Time horizon: 12 months

### Company ratings

<b>Buy</b>	Stock expected to outperform benchmark by more than 15%
<b>Accumulate</b>	Stock expected to outperform benchmark by more than 5% but not more than 15%
<b>Hold</b>	Expected stock relative performance ranges between -5% and 5%
<b>Underperform</b>	Stock expected to underperform benchmark by more than 5%

### Sector ratings

<b>Positive</b>	Sector expected to outperform benchmark by more than 10%
<b>Neutral</b>	Expected sector relative performance ranges between -10% and 10%
<b>Cautious</b>	Sector expected to underperform benchmark by more than 10%

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29-30/F, Li Po Chun Chambers, 189 Des Voeux Road Central, Hong Kong  
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