

28 October, 2016

## Kingdee (268.HK)

Kingdee is a leading ERP software provider in China's SMEs market and a first mover in SaaS cloud business in China. After 4-5 years of investments in cloud business, Kingdee is likely to enjoy fast-growing cloud development amid strong demand for SMEs management and internet plus. It targets to increase cloud business to 50% of total revenue in 2020 from 20% in 1H16. By disposal of three loss-making businesses for the gains of RMB 139 million booked in 2H16, Kingdee more focus on core ERP cloud business. Coupled with its abundant net cash of RMB 5 million in 1H16 and cheaper valuation than its A-share main competitors, Yonyou, Kingdee may be re-rated amid its positive outlook and the kick-starts of Shenzhen-HK Connect.

### Investment Highlights

- ▶ **Kingdee retained 12-consecutive-year leadership in ERP sector and a first mover in SaaS cloud business in China.** Following its strong brand recognition in traditional ERP field, Kingdee recorded a 138% YoY sales growth in cloud business in 1H16. Traditional ERP business recovered to a 6.2% YoY sales growth amid improving distribution channels from direct sales to higher margin indirect sales.
- ▶ **Cloud business which is computing based on the internet enjoys rapid growth in both international and China market** with its features of flexibility, automatic software updates, less expenditure than traditional software and server. According to IDC research, firms' capex on cloud service will reach around 50% of the global IT infrastructure expenditure to USD 59.5 billion by 2020. China cloud computing is expected to reach USD 6.9 billion, representing CAGR of 27.8% during 2012-2017E.
- ▶ **Kingdee expects to more focus on core ERP cloud business by disposal of three loss-making cloud businesses.** Management expects cloud sales to increase from 20% of sales in 1H16 to 50% in 2020. Management expects ERP cloud to have rapid growth going forward amid its initial investment stage. ERP cloud recently had less competitors in China
- ▶ **EBIT margin decreased from 17.2% in 1H15 to 11.1% in 1H16 mainly due to the increased R&D cost and salary cost.** Bad debt expense also increased as management indicates allowances for impairment to be sufficient for over 3 years.
- ▶ **Healthy Balance Sheet.** Kingdee implements usage-based subscription model for cloud business, where customers pay in advance. Those generate stable cash flow and less accounts receivables. Kingdee had healthy balance sheet with net OCF rising by 28.9%yoy and net cash of RMB 5 million in 1H16.

Last price: HK\$ 3.17

### Stock Data

Number of shares outstanding: 2,945 million  
Mkt cap: HK\$9,337 million  
Chairman & CEO: Xu Shao Chun

### Financial Summary

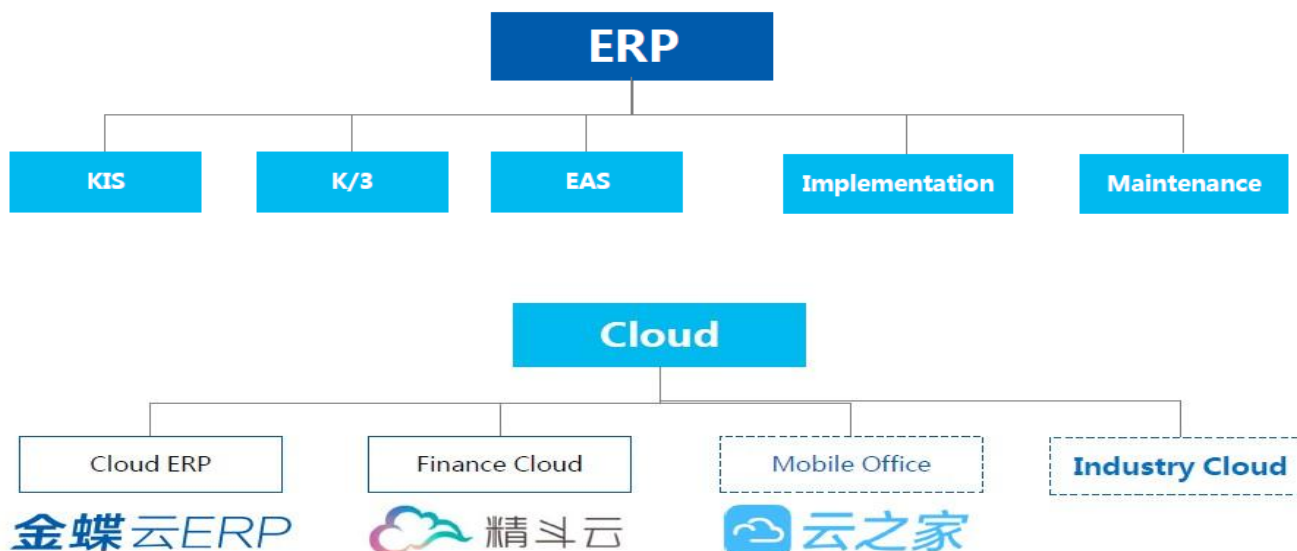
Year-End	FY13A	FY14A	FY15A	1H15A	1H16A
Sales (RMB: '000)	1,602,125	1,546,517	1,586,224	757,981	913,204
Net Profit (RMB: '000)	126,400	197,048	105,766	91,597	134,834
Basic EPS	0.05	0.08	0.04	0.03	0.05
Diluted EPS	0.05	0.07	0.04	0.03	0.04
PE (x)	36.77	24.02	78.01	-	-
PB (x)	2.67	2.39	2.70	-	-

Source: Company

## Company Background

Kingdee is the leading enterprise internet service provider in Asia and provides management software, cloud services and internet finance products to over 6 million enterprises, government agencies, etc. It has been named the “No.1 ERP solutions provider for SMEs” for 12 streak years by IDC research.

### ERP Application Software And Cloud Products



Mobile Office and Industry Cloud have already disposed.  
Source: Company

### Stable profit growth of ERP business

**Kingdee retained leadership in the ERP sector for 12 streak years.** According to IDC report, Kingdee maintained No.1 position in China application software for SMEs in FY15 for 12 streak years. Traditional ERP (Enterprise resource planning) was the biggest field in management software, and its users include manufacturing and logistics, etc.

**ERP business likely have a stable growth.** Following the steps of international ERP players, such as Oracle and SAP, who outsource sales and implementation service to third parties, Kingdee focuses on high margin segment with enhancing distribution channels and shifting the distribution channels from direct sales to indirect sales. Thanks to increasing demand from SMEs financial and supply chain management, Kingdee may recover to stable growth. Thanks to the growing demand for SMEs management, KIS and EAS had 20.1% and 5.4% YoY growth in 1H16. 1H16 YoY drop of 6.3% for K3 results from shifting distribution channels to indirect sales. Management expects to recover back to positive YoY growth in the future.

Sales of ERP Products									
RMB ('000)	1H16	%	1H15	%	1H14	%	1H16 YoY	1H15 YoY	
KIS	155,568	35%	129,567	35%	117,372	32%	20.1%	10.4%	SME demand is growing
K/3	106,486	31%	113,651	31%	119,358	33%	-6.3%	-4.8%	The drops result from shifting distribution channels from direct to indirect channels. Management expects to recover in H16
EAS	107,992	28%	102,450	28%	101,153	28%	5.4%	1.3%	SME demand is growing
Others	22,177	6%	22,515	6%	28,394	8%	-1.5%	-20.7%	
Total ERP Sales	392,223	100%	368,183	100%	366,277	100%	6.5%	0.5%	

Source: Company

## Fast growing cloud business

**Kingdee enjoys leading position in cloud business.** Kingdee has a progressive move to internet plus industry, establishing accounting software since 1993, and then transforming ERP business since 1998 to focus on cloud business in 2012. As a first mover in SaaS services from cloud business and 4-5 years of investment in cloud areas, Kingdee becomes the leader in SaaS cloud areas with strong R&D. Its SaaS products included K/3 ERP cloud, financial Jindou cloud upgraded from YouShang, etc.

**Cloud revenue is likely to be the main revenue growth driver.** Kingdee cooperated with Amazon AWS on Kingdee ERP cloud, which provides large computing calculation. Kingdee ERP cloud has the features of stability and had less competitors in China and had a YoY growth of 137% in 1H16. Jindou Cloud, a financial cloud, was upgraded from the website-based YouShang. Jindou Cloud had mobile functions and recorded a YoY growth of 44% in 1H16. Kingdee signed contracts with Tencent, Coca-Cola, Jaguar, etc, which we expect to provide guaranteed revenue in 2H16, where cloud ERP users pay on an annual basis and generate stable cash flow. Management believes cloud business to have a 10-year market growth as the supports by Chinese government due to national safety reason.

**Cooperating with well-known internet partners.** Kingdee partnerships with giant internet leaders, such as Tencent, JD.com, Kingsoft, and Amazon. Kingdee also cooperated with strategic shareholder, JD.com, which owned 10% stakes of Kingdee, to provide e-commerce management software solution and electronic invoice business.

Sales of Cloud service	Products	1H16 Sales YoY	1H15 Sales YoY	Number of users	Number of customers	Comments
Finance cloud	Jindou Cloud	44.0%	28.1%	over 75,000 (+29%YoY)		No.1 accounting cloud ERP in China Retention ratio of paying users over 75% Jindou cloud was upgraded from YouShang which focused on PC function and the upgrading has strengthened mobile function
ERP cloud	Kingdee Cloud ERP	136.5%	99.7%	over 122,000 (+96%YoY)	over 2,000	No.1 Cloud ERP in China New customers included Tencent, Coca Cola and Jaguar Land Rover
Mobile office	Cloud Hub	67.8%	96.4%	over 10,000,000	over 1,000,000	Disposal. Kingdee still keep 15% of holdings after disposals.
Industry cloud	Kuaidi100	48.9%	75.9%			Disposal
E-commerce cloud	Guanyi Cloud					M&A in 1H16
Total cloud		138.3%	82.1%			

Source: Company

Income Statement	1H16	1H15	2015	2014	1H16	1H15	FY15	FY14	1H16	FY15
RMB('000)					%	%	%	%	YoY	YoY
Sales	913,204	757,981	1,586,224	2,987,009	100.0%	100.0%	100.0%	100.0%	20.5%	-46.9%
-ERP	718,294	676,178	1,395,250	1,440,492	78.7%	89.2%	88.0%	48.2%	6.2%	-3.1%
Direct sales	432,887	409,841	879,237	893,844	60.3%	60.6%	63.0%	62.1%	5.6%	-1.6%
Indirect sales	285,407	266,337	516,013	546,648	39.7%	39.4%	37.0%	37.9%	7.2%	-5.6%
-Cloud	194,910	81,803	190,974	106,025	21.3%	10.8%	12.0%	3.5%	138.3%	80.1%
Cost of sales	-188,687	-158,498	-294,095	-270,687	20.7%	20.9%	18.5%	9.1%	19.0%	8.6%
Gross profit	724,517	599,483	1,292,129	2,716,322	79.3%	79.1%	81.5%	90.9%	20.9%	-52.4%
EBIT Margin	101,079	130,036	226,612	299,312	11.1%	17.2%	14.3%	19.4%	-22.3%	-24.3%

Source: Company

## Robust 1H16 Interim Result

**Robust 1H16 top-line growth.** Kingdee reported robust 1H16 result with a YoY revenue growth of 20 % to RMB 913 million due to the strong performance of cloud business. Net profit grew by 47%yoy to RMB 134 million due to tax gains. 1H16 traditional ERP revenue grew by 6.2%yoy. Cloud service revenue grew by 138%yoy, accounting for 20% of total revenue for the first time. Management indicated cloud service is likely to reach 50% of total revenue within 3 years. We believe Kingdee enjoys rapid expansion on cloud business.

**Healthy balance sheet remains solid.** Kingdee hold abundant cash of RMB 2 billion, accounting for 35% of total assets. Kingdee hold net cash of RMB 5 million in 1H16. High operating cash flow allows Kingdee to invest in high growth areas of cloud ERP products.

**Disposal of loss-making non-core business helps to focus on core ERP and ERP cloud business.** Kingdee disposed of non-core Qianhai Baidi, Kingdee CloudHub and Shanghai Kingdee Medical for RMB 107 million, which reported total net loss of RMB 36 million and RMB 111 million in FY14 and FY15. Kingdee will keep 15% shares of Kingdee Cloudhub. Three disposal businesses only accounted for small parts of total revenue. Kingdee will record a net gain of RMB 139 million in 2H16, which helps 2H16 earnings. Its allows Kingdee to focus on its core ERP and Cloud ERP business.

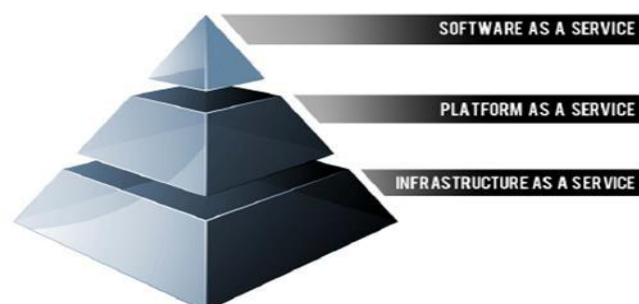
**Narrowing EBIT margin due to the increase in R&D expense and salary paid.** 1H16 EBIT margins was 11.1%, down 6.1pts, due to R&D expenses YoY growth of 37.7% in 1H16. G&A expenses rose by 94.9%yoy due to the increases in bad debt and salaries. Allowance for impairments was RMB119 million, where management expects to be sufficient for over 3 years. Following the increases in cloud revenue which is a usage-based subscription model, management expects that bad debt and account receivables have decreased.

## Cloud Industry Outlook

**Kingdee focused on SaaS cloud service.** Cloud service industry can be classified by three segment, including SaaS (Software as a service) (軟件即服務)、PaaS (Platform as a service) (平台即服務)、(Infrastructure as service) IaaS (基礎設施即服務). Kingdee focused on SaaS, where its products included Jindou Cloud and Kingdee ERP Cloud which are No.1 in accounting cloud and ERP cloud in China.

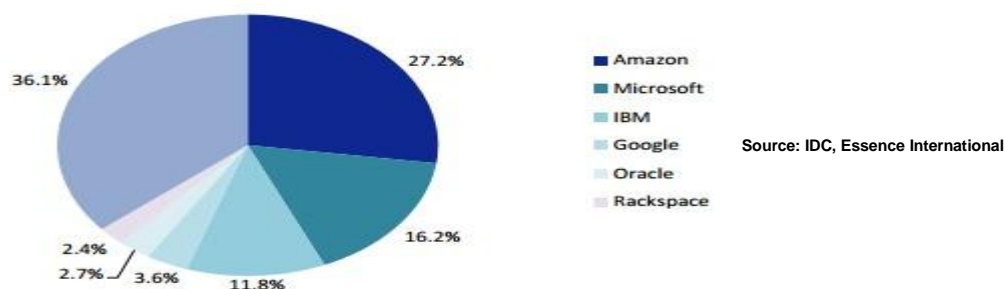
**Cloud business is likely to enjoy a rapid growth amid the increasing demand for SME management and Internet plus service.** According to IDC research, firms' capex on cloud service will reach around 50% of the global IT infrastructure expenditure to USD 59.5 billion by 2020. According to IDC and Essence International, China cloud computing is expected to reach USD 6.9billion, representing CAGR of 27.8% during 2012-2017E. IaaS and PaaS industry leader, such as Amazon AWS and Ali Cloud, had solid industry growth of 59% and 98% over the past 2 years. International SaaS leaders, Salesforce and Netsuite also recorded rapid growth of 28% and 34% over the past 2 years. It suggests the rapid industry growth.

Cloud	On-demand self-service, broad network access, resource pooling, rapid elasticity, measured service	
SaaS	Designed for end-users, delivered over the web	Yahoo mail, Gmail, ERP, CRM, Kingdee Cloud
PaaS	The sets of tools and services designed to make coding and deploying those application quick and efficient	Amazon AWS (Highest market share), Windows Azure, Google App Engine, Yahoo Application Platform
IaaS	Hardware and software that powers servers, storage, networks and operating systems	Amazon EC2, HiCloud

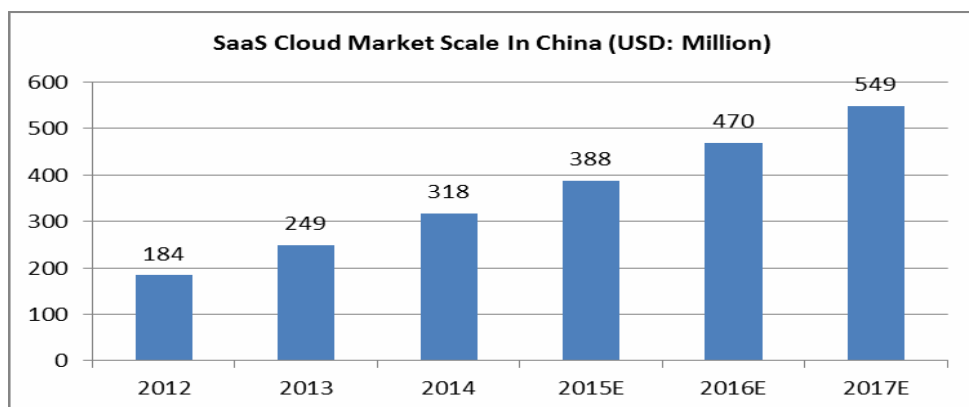


Source: IDC Survey

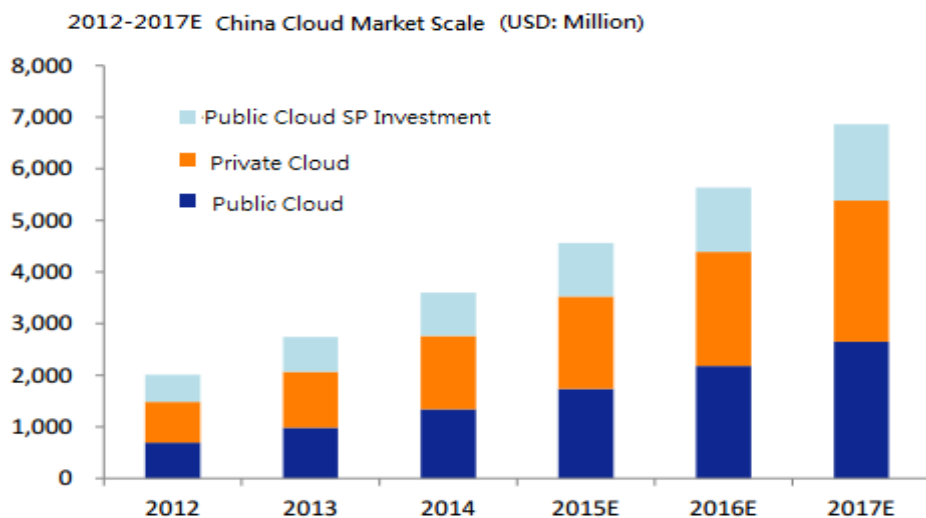
**1H15 Global IaaS Market Scale**



**SaaS Cloud business has rapidly potential growth.** No matter for international and China market, SaaS cloud as a software provider developed later than IaaS/PaaS which are infrastructure and platforms. IaaS cloud moved first among the cloud area, where Amazon AWS, Ali Cloud and Tencent are dominant players. SaaS mostly are in a start-up period, where SaaS cloud providers are mostly SaaS companies and traditional software developers that have transformed into SaaS service providers, such as Kingdee. The latter usually had high brand recognition. Kingdee cooperated with Amazon on Kingdee ERP cloud, where Amazon AWS provided big data and computing calculation. Kingdee also cooperated with JD and Alibaba on Jindou cloud and Guanyi cloud. SaaS cloud has gradually been substituted for traditional software. Traditional software usually is PC-based and it needs large amount of initial licenses, maintenance fee and service upgrading. However, SaaS cloud is more flexible and implements usage-based payment subscription model. SaaS cloud had more cost-saving advantages than traditional software and was more attractive for SME. According to IDC survey, SaaS cloud market scale is expected to reach USD 549 million in 2017, representing CAGR of 24% during 2012-2017E.



Source: IDC, Essence International



Source: IDC, Essence International

## Peer Comparison

**Kingdee had undervalued valuation than its A-share peers.** Although Yonyou had the largest market share in traditional China ERP market, it recorded three-streak quarterly losses and it post net loss of RMB 174 million in 3Q16 under the transitioning pressure on expenses. Yonyou is in the initial stage of transition period to SaaS cloud and finance payment business while a recovered ERP top-line YoY growth of 10.7% cannot offset the loss on cloud business. Kingdee nevertheless had a healthy growth in both traditional ERP and cloud business as it enjoys first mover advantages in SaaS cloud area.

Name	Price	Market cap (HK\$m)	PE FY16E	PB FY16E	ROE FY16E	
Application Software						
268 HK Equity	KINGDEE	3.17	9,337	28.0	2.3	8.8
600588 CH Equity	YONYOU	22.92	38,387	81.0	5.7	7.3
SAP US Equity	SAP SE-SPONS ADR	87.89	837,278	21.3	3.8	17.8
ORCL US Equity	ORACLE CORP	38.17	1,215,227	14.5	3.4	23.9
CRM US Equity	SALESFORCE.COM	75.13	399,078	79.4	8.0	13.2
600718 CG Equity	NEUSOFT CORP-A	17.59	25,012	53.3	2.5	13.5

Source: Bloomberg

## Financial Statement

### Income Statement

RMB ('000)	1H16	1H15	2015	2014	1H16 Margin	1H15 Margin	FY15 Margin	FY14 Margin	1H16 YoY	FY15 YoY
Sales	913,204	757,981	1,586,224	1,546,517	100.0%	100.0%	100.0%	100.0%	20.5%	2.6%
-ERP	718,294	676,178	1,395,250	1,440,492	78.7%	89.2%	88.0%	93.1%	6.2%	-3.1%
-Direct sales	432,887	409,841	879,237	893,844	60.3%	60.6%	63.0%	62.1%	5.6%	-1.6%
-Indirect sales	285,407	266,337	516,013	546,648	39.7%	39.4%	37.0%	37.9%	7.2%	-5.6%
-Cloud	194,910	81,803	190,974	106,025	21.3%	10.8%	12.0%	6.9%	138.3%	80.1%
Cost of sales	-188,687	-158,498	-294,095	-270,687	20.7%	20.9%	18.5%	17.5%	19.0%	8.6%
Gross profit	724,517	599,483	1,292,129	1,275,830	79.3%	79.1%	81.5%	82.5%	20.9%	1.3%
Selling and marketing expense	-471,650	-397,628	-854,564	-784,480	51.6%	52.5%	53.9%	50.7%	18.6%	8.9%
Administrative expense	-135,977	-69,770	-257,788	-202,198	14.9%	9.2%	16.3%	13.1%	94.9%	27.5%
R&D costs	-146,748	-106,537	-234,820	-223,446	16.1%	14.1%	14.8%	14.4%	37.7%	5.1%
Fair value gain on investment property			17,582	4,536	0.0%	0.0%	1.1%	0.3%		287.6%
Other gains-net	132,470	104,573	266,288	229,676	14.5%	13.8%	16.8%	14.9%	26.7%	15.9%
Operating profit	102,612	130,121	228,827	299,918	11.2%	17.2%	14.4%	19.4%	-21.1%	-23.7%
Finance income	15,353	15,331	29,907	23,837	1.7%	2.0%	1.9%	1.5%	0.1%	25.5%
Finance costs	-32,833	-47,284	-94,254	-97,316	3.6%	6.2%	5.9%	6.3%	-30.6%	-3.1%
Finance nets	-17,480	-31,953	-64,347	-73,479	1.9%	4.2%	4.1%	4.8%	-45.3%	-12.4%
Share of loss of investments accounting for using the equity method	-1,533	-85	-2,215	-606	0.2%	0.0%	0.1%	0.0%	1703.5%	265.5%
Profit before tax	83,599	98,083	162,265	225,833	9.2%	12.9%	10.2%	14.6%	-14.8%	-28.1%
Income tax expense	41,629	-7,639	-56,748	-25,485	4.6%	1.0%	3.6%	1.6%	-645.0%	122.7%
Net profit	125,228	90,444	105,517	200,348	13.7%	11.9%	6.7%	13.0%	38.5%	-47.3%

Profit attributed to equity owners	134,834	91,597	105,766	197,048	14.8%	12.1%	6.7%	12.7%	47.2%	-46.3%
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Source: Company

## Balance Sheet

RMB ('000)	1H16	2015	2014
Land use rights	127,086	128,766	132,127
PPE	837,440	731,783	728,218
Intangible assets	902,025	601,218	577,065
Investment in associates	27,689	24,222	831,159
Investment properties	848,741	848,741	1,537
Financial assets at fair value through P&L	6,000	6,000	0
Entrusted loan	69,400	69,500	20,000
<b>Total non-current assets</b>	<b>2,818,381</b>	<b>2,410,230</b>	<b>2,290,106</b>
Inventories	6,483	4,047	3,926
Trade and other receivables	336,294	277,875	244,469
Entrusted loan	300	300	25,600
Due from customers on implementation contracts	406,813	391,193	301,112
Available for sale financial assets	121,826	225,177	0
Financial assets at fair value through P&L	900	1,267	0
Pledged bank deposits	62,832	102,832	7,038
Short term bank deposits	787,724	543,658	259,283
Cash and cash equivalents	1,165,137	1,527,610	1,261,634
<b>Total current assets</b>	<b>2,888,309</b>	<b>3,073,959</b>	<b>2,103,062</b>
Share capital	72,441	71,972	65,155
Share premium	1,729,742	1,682,784	537,920
Other reserves	515,017	512,763	512,113
Retained earnings	1,084,384	949,550	873,784
	<b>3,401,584</b>	<b>3,217,069</b>	<b>1,988,972</b>
Non controlling interests	50,729	29,649	9,246
<b>Total equity</b>	<b>3,452,313</b>	<b>3,246,718</b>	<b>1,998,218</b>
Borrowings	1,471,405	1,213,018	1,291,397
Deferred income tax liabilities	74,324	105,738	74,192
<b>Total non-current liabilities</b>	<b>1,545,729</b>	<b>1,318,756</b>	<b>1,365,589</b>
Trade and other payables	374,124	357,390	302,967
Due to customers on implementation contracts	175,130	183,991	80,573
Borrowings	41,013	243,500	545,579
Current income tax liabilities	18,151	37,262	23,191
Deferred income	100,230	96,572	77,051
<b>Total current liabilities</b>	<b>708,648</b>	<b>918,715</b>	<b>1,029,361</b>



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Hold	Stocks with potential return of between -15% to +15% over the next 12 months
Sell	Stocks with potential negative return exceeding -15% over the next 12 months
Speculative Buy	Stocks with potential positive return exceeding 20% over the next 6 months, with high volatility
Speculative Sell	Stocks with potential negative return exceeding -20% over the next 6 months, with high volatility
Sector Rating	Remarks
Overweight	Relative performance over Hang Seng Index $\geq 10\%$
Neutral	Relative performance within Hang Seng Index -10% to +10%
Underweight	Relative performance below Hang Seng Index $\leq -10\%$

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