

COMPANY RESULTS

Kingsoft Corp (3888 HK)

2Q23: Strong Top-line Growth; Solid Progress On Game Pipeline And WPS AI

Kingsoft's 2Q23 results were better than expectations. Revenue grew 20% yoy to Rmb2.2b, in line with the street's estimate. Gross margin expanded 3.5ppt yoy to 83.5%, 2% above the street's expectation. Non-IFRS operating profit surged 59% yoy to Rmb767m, while operating margin expanded 8ppt yoy to 35%, driven by better operating efficiency and improved WPS margin. Net profit was Rmb251m, up 6.5% qoq, slightly below our expectation. Maintain BUY with a higher target price of HK\$40.00.

2Q23 RESULTS

Year to 31 Dec (Rmbm)	2Q22	1Q23	2Q23	qoq % chg	yoy % chg	UOB	Var	Cons	Var
TOTAL REVENUE	1,834	1,970	2,193	11.3%	19.6%	2,198	(0.2%)	2,178	0.7%
Online Game	910	919	1,073	16.8%	17.9%	955	12.3%		
Office Software & Others	925	1,052	1,121	6.6%	21.2%	1,243	(9.8%)		
Cost of services	-366	-345	-362	(4.9%)	1.3%	-418	13.4%		
Gross profit	1,468	1,625	1,832	12.7%	24.8%	1,780	2.9%	1,773	3.3%
online game GPM	65%	63%	73%	10.2 ppt	8.2 ppt	77%	-4 ppt		
WPS GPM	95%	99%	93%	(6.1 ppt)	(1.4 ppt)	84%	9 ppt		
online game OPM	13%	13%	20%	6.7 ppt	6.9 ppt	10%	10 ppt		
WPS OPM	32%	32%	41%	9.0 ppt	8.8 ppt	27%	14 ppt		
Non-IFRS Operating profit	482	533	767	43.8%	59.2%	510	50.2%	510	50.4%
Non-IFRS OPM	26%	27%	35%	7.9 ppt	8.7 ppt	23%	11.7 ppt		
Non-IFRS net profit	-83	236	251	6.5%	401.6%	273	(8.1%)		
Diluted EPS (RMB)	-0.11	0.14	0.04	(71.4%)	136.4%	0.00	100.0%		
GPM	80.0%	82.5%	83.5%	1.0 ppt	3.5 ppt	81.0%	3 ppt	81.4%	2.1 ppt
Net margin	-4.5%	12.0%	11.4%	(0.5 ppt)	16.0 ppt	12.4%	-1 ppt		

Source: Kingsoft Corp Ltd, UOB Kay Hian

RESULTS

- Reviving online games' revenue performance.** Kingsoft Corp's (Kingsoft) online games' revenue ramped up by 18% yoy to Rmb1.1b (vs 1Q23: -6%, 2Q22: +31%) in 2Q23, mainly bolstered by strong performance in revenue of JX Online III due to continuous updates and optimisations of user experience. However, this was partially offset by decline in revenue from the existing mobile games such as JX World III and JX I: Gui Lai. The company expects positive growth in games revenue in the following quarters. Full-year guidance for online games' revenue remains unchanged at single-digit yoy growth. Operating margin for 2023 is guided to be flat yoy.
- Soft Kingsoft Office (KO, or WPS) performance.** KO revenue maintained a solid growth of 21% at Rmb1121m (vs 1Q23: +21%, 2Q22: +18%) but dragged by weak IT innovation (XinChuang) orders from the government although the gap was narrowed. By segment, personal and institutional subscription revenue growth was 33.2% and 40.4% yoy in 2Q23 but ToB licence growth missed street estimates at -14% yoy. 2Q23 net profit soared by 106% yoy to Rmb332m thanks to stringent cost control, despite a rise in AI-related costs.
- Margin performance.** Total opex as a percentage of total revenue declined to 53% in 2Q23 from 57% in 2Q22. S&M expenses grew 6% yoy, due to increased commitment towards design, research and development and sales and marketing of the office software products and services of WPS Office as well as expansion of presence in the domestic enterprise market.

KEY FINANCIALS

Year to 31 Dec (Rmbm)	2021	2022	2023F	2024F	2025F
Net turnover	6,371	7,637	8,828	10,848	12,379
EBITDA	1,668	2,215	2,602	3,003	3,863
Operating profit	1,361	1,869	2,185	2,384	3,030
Net profit (rep./act.)	395	(6,049)	647	1,169	1,681
Net profit (adj.)	(228)	711	1,015	1,550	2,116
EPS (Fen)	(16.3)	49.6	74.3	113.5	154.1
PE (x)	n.m.	56.1	37.4	24.5	18.1
P/B (x)	1.1	1.6	1.5	1.4	1.4
EV/EBITDA (x)	10.0	7.5	6.4	5.6	4.3
Dividend yield (%)	0.0	0.0	0.0	0.0	2.9
Net margin (%)	6.2	(79.2)	7.3	10.8	13.6
Net debt/(cash) to equity (%)	(49.4)	(73.9)	(82.3)	(83.2)	(83.0)
Interest cover (x)	n.a.	n.a.	n.a.	n.a.	n.a.
ROE (%)	1.2	n.a.	2.6	4.5	6.2
Consensus net profit	-	-	717	1,158	1,664
UOBKH/Consensus (x)	-	-	1.42	1.34	1.27

Source: Kingsoft Corp, Bloomberg, UOB Kay Hian

n.m. : not meaningful; negative P/E, EV/EBITDA reflected as "n.m."

BUY

(Maintained)

Share Price	HK\$29.90
Target Price	HK\$40.00
Upside	+33.8%
(Previous TP)	HK\$37.00

COMPANY DESCRIPTION

The company is a leading provider of software and internet service.

STOCK DATA

GICS sector	Communication Services
Bloomberg ticker:	3888 HK
Shares issued (m):	1,365.5
Market cap (HK\$m):	40,829.4
Market cap (US\$m):	5,209.4
3-mth avg daily t'over (US\$m):	29.5

Price Performance (%)

52-week high/low HK\$41.80/HK\$18.36

1mth	3mth	6mth	1yr	YTD
(8.0)	(1.5)	11.8	22.8	14.6

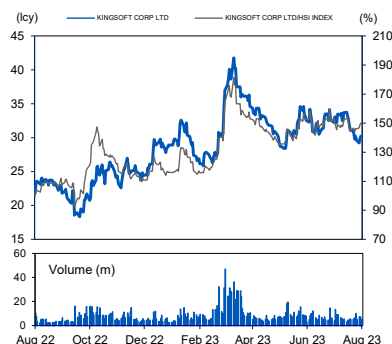
Major Shareholders

	%
Lei Jun	22.6
TCH Saffron Ltd	7.8
Pak Kwan Kau	7.3

FY23 NAV/Share (Rmb) 18.50

FY23 Net Cash/Share (Rmb) 15.23

PRICE CHART



Source: Bloomberg

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STOCK IMPACT

- Better visibility of online games pipeline.** In 2H23, the game pipeline includes the recently launched Snowbreak: Containment Zone, as well as World of JX Origin, which is expected to be launched by end-Sep 23 or early-Oct 23. Several other games are currently undergoing testing and will be launched in the coming years. This includes a shooting and mechanics-oriented game under testing, a mobile version of JX Online III set for 2024, and a new version planned for 2025. Core development focus will lie in 4Q23 as the company expects potential competition in the market and the launch of new anime mobile games. With the launch of the upgraded 2.0 version of JX Online III by end-23, Kingsoft is confident in its performance in the upcoming quarters.
- AI application within the gaming business.** Kingsoft initiated experiments with various AI applications, primarily focusing on achieving more automated character control (MPC), enhancing the game engine, and partially involving non-core visual artistic functions and content provision. The key application area for AI in games remains centred around 3D visual artistic aspects. Kingsoft is actively exploring and refining AI technologies in this field, aiming to incorporate more AI applications within the gaming business.
- Meaningful progress of AI assistant, WPS AI, introduced by Kingsoft Office.** WPS AI is powered by extensive language models, and launched its Open Beta program internationally. Furthermore, the company rolled out the spring version of WPS Office, enhancing its functionalities and offering a seamless experience through cloud integration. Positive user feedback has been garnered for AI functions introduced in WPS AI products, though not all functions have been officially launched. The company is working on refining these functions and addressing user interest in their official release and potential monetisation.
- Margin outlook.** Given weaker seasonality and heightened promotional expenses for new game launches, operating margin in 3Q23 is expected to be lower than in 2Q23. Nonetheless, for 2023, Kingsoft aims to maintain a healthy operating margin level. For Kingsoft Office, the company anticipates a relatively stable operating margin in 2H23.
- Cloud overview.** For 2Q23, Kingsoft Cloud generated negative revenue growth of 3.7% yoy. Public cloud services revenue declined 10% yoy, attributed to proactive scaling down of CDN services. Enterprise cloud services revenue ramped up 9.5% yoy, primarily supported by continuous focus on selected verticals and high-quality projects coupled with smoother and standard delivery processes. Non-GAAP net loss was Rmb315m in 2Q23, significantly narrowing from a net loss of Rmb412.5m in 1Q23.

EARNINGS REVISION/RISK

- We raise our 3Q23 revenue forecast by 3% but keep our 2023 revenue forecast unchanged** in view of management's positive view on online games outlook in 2H23. We expect Kingsoft to deliver adjusted net profit of Rmb237m in 3Q23, which should translate to net margin of 11% vs 27% in 3Q22.
- Risk.** Obsolescence of its flagship PC games and delays in the government software localisation project.

VALUATION/RECOMMENDATION

- Maintain BUY with a slightly higher target price of HK\$40.00.** We remain cautiously optimistic on the company due to the promising game pipeline coupled with intensified market competition. Our target price implies 47.8x 2023F PE. The company is currently trading at 36x 12-month forward PE, lower than its historical mean of 46x.

SHARE PRICE CATALYST

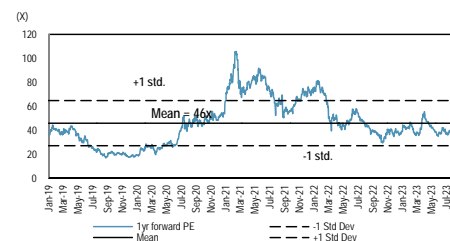
- a) Continued launch of expansion packs to support online games growth; and b) growth in WPS revenue from licensed software and subscription services.**

SOTP VALUATION

HK\$(m)	FY23-24F revenue	FY22-24F revenue CAGR	FY23-24F non-GAAP earnings	Assumed FY23-24F PER	Assumed FY23-24F EV/SALES	Fair value HK\$(m)	Kingsoft's holding (or share of total revenue)	Fair value per share (HK\$)
Online games	4,985	9%	997	5x		4,985	84%	3
WPS	5,946	16%	1,427	42x	10x	71,348	53%	22
Cheetah						484	47%	0
Cloud						10,120	52%	3
Total EV with 20% discount								23
2023-24F cash per share						20,803		17
Target price (HK\$)								40.00

Source: Kingsoft, UOB Kay Hian

12-MONTH FORWARD PE BAND



Source: Bloomberg, UOB Kay Hian

PROFIT & LOSS

Year to 31 Dec (Rmbm)	2022	2023F	2024F	2025F
Net turnover	7,637	8,828	10,848	12,379
EBITDA	2,215	2,602	3,003	3,863
Deprec. & amort.	346	417	619	833
EBIT	1,869	2,185	2,384	3,030
Total other non-operating income	(6,500)	(61)	0	0
Associate contributions	(1,382)	(1,203)	(1,203)	(1,203)
Net interest income/(expense)	292	318	318	415
Pre-tax profit	(5,721)	1,239	1,499	2,242
Tax	379	(236)	(330)	(560)
Minorities	(707)	(356)	0	0
Net profit	(6,049)	647	1,169	1,681
Net profit (adj.)	711	1,015	1,550	2,116

BALANCE SHEET

Year to 31 Dec (Rmbm)	2022	2023F	2024F	2025F
Fixed assets	1,551	2,482	3,523	4,589
Other LT assets	6,797	4,948	3,677	2,810
ST debt	n.a.	n.a.	n.a.	n.a.
Cash/ST investment	18,201	20,803	21,998	23,354
Other current assets	5,338	4,414	5,423	6,189
Total assets	31,888	32,647	34,621	36,941
Other current liabilities	4,476	4,598	5,413	6,062
LT debt	0	0	0	0
Other LT liabilities	843	843	843	843
Shareholders' equity	24,625	25,272	26,441	28,122
Minority interest	(469)	(479)	(489)	(499)
Total liabilities & equity	31,888	32,647	34,621	36,941

CASH FLOW

Year to 31 Dec (Rmbm)	2022	2023F	2024F	2025F
Operating	2,007	1,793	1,276	1,982
Pre-tax profit	(5,721)	1,239	1,499	2,242
Tax	379	(236)	(330)	(560)
Deprec. & amort.	346	417	619	833
Working capital changes	503	1,047	(195)	(117)
Other operating cashflows	6,500	(674)	(318)	(415)
Investing	(513)	501	(389)	(1,030)
Capex (growth)	(1,146)	(1,324)	(1,627)	(1,857)
Others	632	1,825	1,238	827
Financing	(587)	308	308	405
Dividend payments	0	0	0	0
Others/interest paid	(587)	308	308	405
Net cash inflow (outflow)	907	2,602	1,194	1,357
Beginning cash & cash equivalent	16,190	18,201	20,803	21,998
Changes due to forex impact	1,104	0	0	0
Ending cash & cash equivalent	18,201	20,803	21,998	23,354

KEY METRICS

Year to 31 Dec (%)	2022	2023F	2024F	2025F
Profitability				
EBITDA margin	29.0	29.5	27.7	31.2
Pre-tax margin	(74.9)	14.0	13.8	18.1
Net margin	(79.2)	7.3	10.8	13.6
ROA	n.a.	2.0	3.5	4.7
ROE	n.a.	2.6	4.5	6.2
Growth				
Turnover	19.9	15.6	22.9	14.1
EBITDA	32.8	17.5	15.4	28.6
Pre-tax profit	(600.5)	n.a.	21.0	49.5
Net profit	(1,630.2)	n.a.	80.8	43.8
Net profit (adj.)	n.a.	42.7	52.7	36.5
EPS	n.a.	49.7	52.7	35.8
Leverage				
Debt to total capital	0.0	0.0	0.0	0.0
Debt to equity	0.0	0.0	0.0	0.0
Net debt/(cash) to equity	(73.9)	(82.3)	(83.2)	(83.0)
Interest cover (x)	n.a.	n.a.	n.a.	n.a.

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