

# Xiaomi (1810 HK)

## IPO NOTE

Open date for public offer	25-Jun
Closing date for public offer	28 Jun 12nn
Commence Trading on HKE	9-Jul

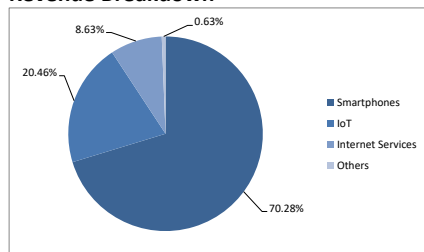
### Summary

Issue price (HK\$)	17 - 22
Total share offer size (HK\$ bn)	37.1 - 48.0
Sponsor:	Goldman Sachs, Morgan Stanley, CLSA
Industry Sector	Technology

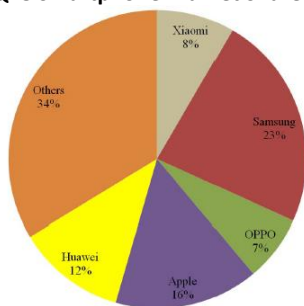
### Company Description

World's fourth largest smartphone company based on total shipments. The company produces low-cost but high-specification smartphones and strives to create an ecosystem of connected smart devices.

### Revenue Breakdown



### 1Q18 Smartphone Market Share



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## World's largest tech IPO since 2014

### Event

Xiaomi plans to raise around US\$6bn at HK\$17-22/share in the world's largest tech listing since Alibaba in 2014.

### Beyond hardware; creating the world's largest ecosystem of internet services.

Xiaomi is the world's 4<sup>th</sup> largest smartphone company based on smartphone shipments. It produces low-cost but high-specification handsets and strives to create an ecosystem of devices such as drones or rice cookers that could be controlled from smartphones. Its internet of things (IoT) platform (excluding smartphones and laptops) is the world's largest with over 100 million connected devices and their innovative internet services have 190 million monthly active users.

**Strong growth in higher margin segments.** Xiaomi's smartphones and IoT/lifestyle device sales make up more than 90% of total revenues but gross profit margins are low at only 8%. Its internet services segment makes up 10% of total revenues but has higher gross profit margins of 60% and has grown at an average of 77% YoY since 2015. For 2017, 39% of gross profits came from internet services. Given that the firm sells its hardware at close to cost prices, internet services should become the key segment of Xiaomi's growth in the coming years.

### Valuation & Action

Valuation based on earnings is not possible given that the group has been loss-making in 2 of the last 3 years. In comparison, global smartphone makers Apple Inc (AAPL US) and Samsung Electronics (005930 KS) trade at 6x to 16x 2018 EPS with positive earnings and cash flows. Tencent (700 HK), which owns the largest Chinese Android App store and a competitor to Xiaomi's MIUI App store, trades at 37/28/21x 2018/19/20 EPS and generated US\$15bn free cash flow in 2017.

In 2017, Xiaomi reported a loss of RMB 44 bn. It expects its expenses to increase in the future due to expansion into markets like Europe and Southeast Asia and investments into R&D. Xiaomi plans to spend 30% of IPO proceeds on R&D while 30% will be used on global expansion. Another 30% will be used to expand and strengthen its ecosystem while 10% will be used for working capital purposes.

### Risks

Xiaomi's internet services monetisation strategy has worked very well in China as Google play is banned in China and users of its android platform are dependent on Xiaomi's platforms for apps and games. Outside of China, this might be a risk due to competition. Global competition is intense due to the dominance of established brands like Apple and Samsung, who both have a combined market share of almost 40% of the global smartphone market (1Q18 shipments). In comparison, Chinese brands like Huawei, Xiaomi and Oppo have 12%, 8% and 7% of market share, respectively.

Additionally, Xiaomi could face pushbacks against Chinese smartphone vendors in the US after Huawei lost out to AT&T due to national-security concerns and ZTE was banned by the Commerce Department from buying from US suppliers for the next 7 years.

**Xiaomi Financial Summary**

**Figure 1: Financial summary - Internet services segment is expected to be key earnings driver for the group**

Revenue(mn Rmb)	2015		2016		2017	
Overall	66,811	% of total	68,434	% of total	114,624	% of total
-Smartphone	53,715	80.4%	48,764	71.3%	80,564	70.3%
-IoT & Lifestyle Products	8,691	13.0%	12,415	18.1%	23,448	20.5%
-Internet Services	3,239	4.8%	6,538	9.6%	9,897	8.6%
-Others	1,166	1.7%	717	1.0%	717	0.6%

Gross Profit(mn Rmb)	2015		2016		2017	
Overall	2,700	% of total	7,249	% of total	15,154	% of total
-Smartphone	(171)	-6.3%	1,682	23.2%	7,101	46.9%
-IoT & Lifestyle Products	35	1.3%	1,013	14.0%	1,951	12.9%
-Internet Services	2,079	77.0%	4,208	58.1%	5,961	39.3%
-Others	757	28.0%	346	4.8%	141	0.9%

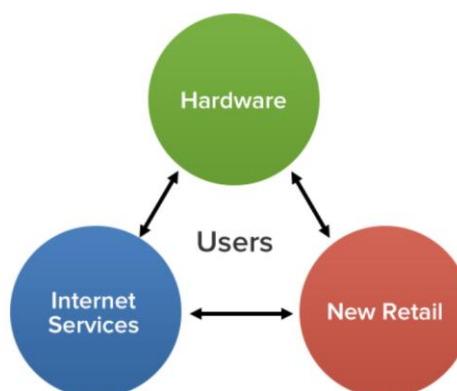
Gross Margin	2015	2016	2017
Overall	4.0%	10.6%	13.2%
-Smartphone	-0.3%	3.4%	8.8%
-IoT & Lifestyle Products	0.4%	8.2%	8.3%
-Internet Services	64.2%	64.4%	60.2%
-Others	64.9%	48.3%	19.7%

Source: IPO Prospectus, KGI Research

**Business Overview**

Xiaomi was founded by Lei Jun and his co-founders in 2010 with a focus to design high quality products at accessible prices to the world. The company’s annual sales exceeded US\$1bn 2 years after inception and exceeded US\$10bn 4 years after inception, the fastest in history. Currently, its revenue comes from the sales of products (smartphones, internet of things, lifestyle products), advertising services and internet value-added services (including online games). The company focuses on a triathlon business model, which creates synergies among its revenue segments by cross-selling services and products to users through its new retail concept, which focuses on direct online sales to maximize efficiency and build a direct digital relationship with users.

**Figure 1: Triathlon Business Model**



Source: IPO Prospectus, KGI Research

### Hardware

Xiaomi offers a broad range of hardware products that are developed in-house or in collaboration with their ecosystem partners. These products are offered at near cost prices with good quality and design. Examples include products such as smartphones, laptops, smart TVs, AI speakers and smart routers. Currently, its ecosystem has over 210 companies and more than 90 companies are focused on the development of internet of things (IoT) products. Among IoT products and smartphones, IoT products are expected to grow at more than twice the speed of smartphones.

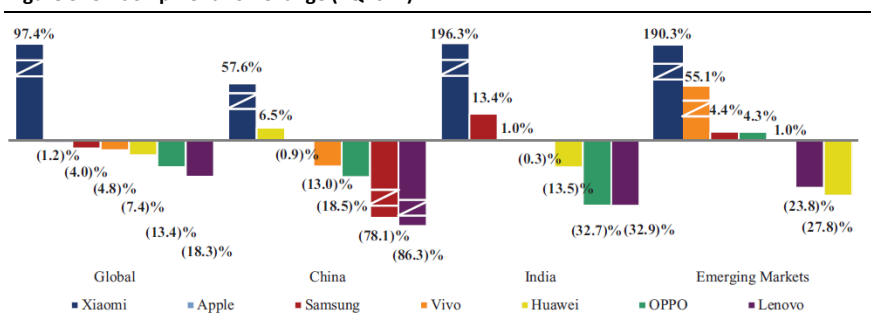
Global smartphone sales grew from US\$425.8bn to US\$458.5bn between 2015 and 2017. This growth is expected to continue at a 4.6% CAGR to US\$573.7bn by 2022, driven by increased smartphone adoption globally as rising income levels and consumer spending creates increasing demand for better smartphones, alongside a higher internet penetration rate, driven by 5G networks. Xiaomi is ranked 1<sup>st</sup> in India and 4<sup>th</sup> globally by unit shipments of smart phone vendors with strong growth across regions.

**Figure 2: Smartphone Vendor Market Share Ranking (4Q2017)**

Company	Smartphone Vendor 4Q2017 Market Share Ranking by Unit Shipments			
	Global	Mainland China	India	Emerging Markets <sup>(1)</sup>
Xiaomi	4 <sup>th</sup> (7.2%)	4 <sup>th</sup> (13.9%)	1 <sup>st</sup> (26.8%)	3 <sup>rd</sup> (7.3%)
Apple	1 <sup>st</sup> (19.7%)	5 <sup>th</sup> (12.9%)	9 <sup>th</sup> (2.8%)	2 <sup>nd</sup> (8.5%)
Huawei	3 <sup>rd</sup> (10.7%)	1 <sup>st</sup> (21.3%)	15 <sup>th</sup> (0.8%)	4 <sup>th</sup> (7.0%)
Lenovo	8 <sup>th</sup> (3.1%)	26 <sup>th</sup> (0.1%)	4 <sup>th</sup> (5.6%)	5 <sup>th</sup> (5.5%)
OPPO	5 <sup>th</sup> (6.9%)	2 <sup>nd</sup> (17.5%)	5 <sup>th</sup> (4.9%)	7 <sup>th</sup> (4.4%)
Samsung	2 <sup>nd</sup> (18.9%)	9 <sup>th</sup> (1.0%)	2 <sup>nd</sup> (24.2%)	1 <sup>st</sup> (29.9%)
Vivo	6 <sup>th</sup> (6.0%)	3 <sup>rd</sup> (16.5%)	3 <sup>rd</sup> (6.5%)	9 <sup>th</sup> (2.8%)

Source: IPO Prospectus, KGI Research

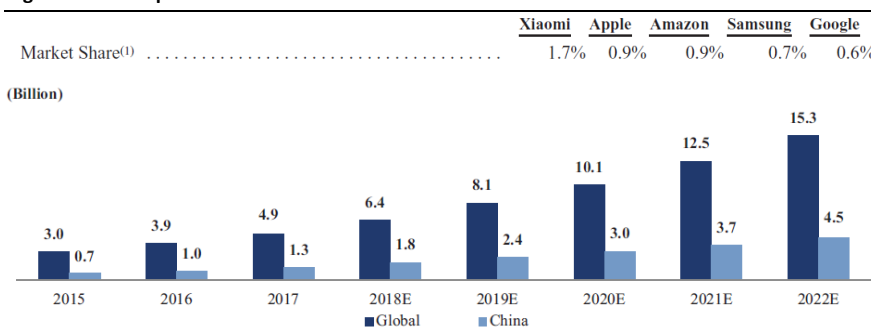
**Figure 3: Unit Shipment YoY Change (4Q2017)**



Source: IPO Prospectus, KGI Research

Sales of consumer IoT hardware grew at a CAGR of 26% from 2015 to 2017 and are expected to reach US\$1.5tn by 2022. As a result, there has been a rapid increase in the amount of connected IoT devices surrounding consumers, with the number of IoT endpoints expected to reach 15.3bn by 2022, representing a CAGR of 25.4% between 2017 and 2022. The firms in the table below leads the IoT platform globally, in terms of the number of connected devices.

**Figure 4: IoT Endpoint Installed Base and Market Share**



Source: IPO Prospectus, KGI Research

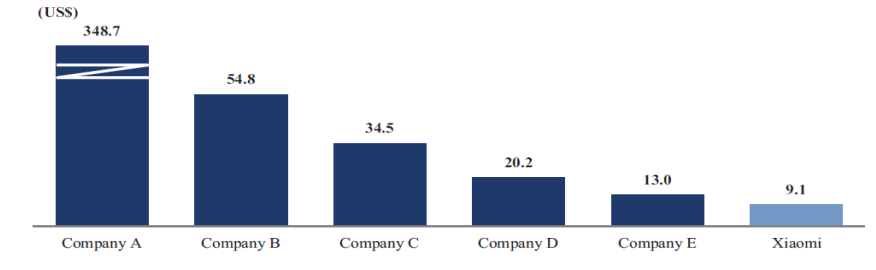
**Internet Services Market**

Revenues from internet services are derived primarily from advertising and other internet value-added services, including online games, cloud storage and cloud computing services through the Mi Cloud.

As of March 2018, Xiaomi has 190 million monthly active users (MAUs) on the Mi User Interface (MIUI), a proprietary operating system built on the Android operating system which allows users to download mobile apps from the Android ecosystem. Including the Mi App Store, Mi Browser, Mi Music and Mi Video Apps, the company has 38 apps with more than 10 million MAUs and 18 apps with more than 50 million MAUs.

The global internet services market grew at a CAGR of 23.5% in 2015 to 2017 and is expected to reach US\$2.6tn by 2022. While user monetisation of major internet services players vary, Xiaomi’s average internet services revenue per user stands at US\$9.1 in 2017, providing them with significant room for further growth when compared to other leading internet players.

**Figure 5: 2017 Internet Services Revenue Per MAU for Global Leading Internet Companies**



Source: IPO Prospectus, KGI Research

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<b>Rating</b>	<b>Definition</b>
	KGI Securities Research's recommendations are based on an Absolute Return rating system.
<b>BUY</b>	>10% total return over the next 12 months
<b>HOLD</b>	-10% to +10% total return over the next 12 months
<b>SELL</b>	<-10% total return over the next 12 months

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