Equity Research l China l Telecommunications

29 July 2015

China telecoms sector

Rising imbalance makes a case for industry restructuring

	Ticker	Rec	Mkt cap (US$m)	Price (HK$)	PT (HK$)	Up/ dn (%)	PER (x) 2015E	PER (x) 2016E	EV/EBITDA (x) 2015E	EV/EBITDA (x) 2016E	Yield (%) 2015E	Yield (%) 2016E
China Telecom	728 HK	Outperform	4.3	4.30	6.5	51.2	15.2	13.6	3.9	3.8	2.2	2.5
China Unicom	762 HK	Outperform	10.6	10.56	16.5	56.3	15.8	13.8	3.4	3.3	2.4	3.0
China Comservice	552 HK	Outperform	3.0	3.39	5.5	62.2	7.7	7.1	3.1	2.7	3.9	4.2
CITIC Telecom	1883 HK	Outperform	1.5	3.50	4.2	20.0	15.0	14.1	9.2	9.0	3.3	3.5

Source: Company data, CSCI estimates, prices as of 28 July 2015

- **Since early 2014, there has been an imbalanced development of the telecoms industry in China. The granting of the FDD LTE licenses appare not to have reverted this inequilibrium in our view.**
- **With deepending SOE reform in China, we see a rising likelihood for China to start another restructuring of the telecoms industry in the near term.**
- **A merger of China Telecom (CT) and China Unicom (CU) could lead to more healthy industry development in the long run, with substantial capex savings, costs reduction and operating synergies.**

Industry imbalance still prominent

Since 2008 (with an industry consolidation), there has been a healthy development of the telecoms industry in China that sees China Mobile (CM) ceding mobile subs market share to smaller ones. However, there is still prominent inequilibrium in the mobile market with CM still holding 63% mobile subs market share (as of Jun 2015, versus 62.2% as of Dec 2013. The granting of the FDD LTE licenses to CT and CU appears not to have reverted the industry inequilibrium to our observation.

Restructuring to lead to more healthy industry development

The deepending SOE reform in China provides a favourable backdrop for telecoms restructuring in our view. Among various restructuring options, we see the neccessity for a merger of CT and CU, which would lead to more healthy industry development in the long run as well as substantial capex savings and costs reduction in our view. Along with the merger, the government should also deepen the mix private-state ownership reform and / or create a third telco by granting full telecoms licenses to the newly established national broadband and television network corporation.

Attractive sector valuation

After 15-30% share price pullback, the sector's current valuation looks more attractive, compared either with its historical valaution or major regional telcos' valuation. Unlike the cyclical sectors, the telecoms industry is likely back on track towards sustainable earnings growth given 1) stabilizing capex, 2) strong mobile data growth, and 3) room for costs reduction.

Without changing forecasts, we reiterate our Outperform ratings on CT and CU on the back of 1) attractive valuation, 2) solid earnings growth, and 3) likelihood of beneficiaries of an industry restructuring.

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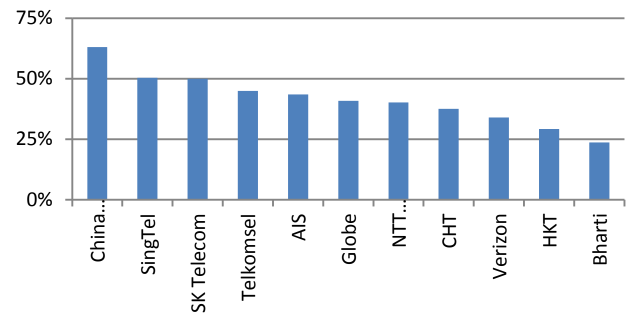
Industry imbalance still prominent

Since the telecoms industry restructuring in 2008 (with former China Unicom and China Netcom being merged), the telecoms industry in China has evolved towards a more balanced structure that sees CM cedes mobile subs market share to CT and CU. However, there is still a prominent imbalance in both the fixed-line and mobile telecoms market in China.

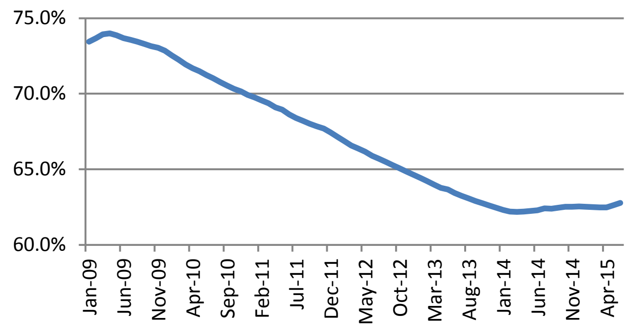
In the mobile market, CM has seen its mobile subs market share falling from 74.0% (as of Jan 2009) to 63.0% (as of Jun 2015), which instead is still much higher than most of market leaders' mobile subs market shares in other markets with a range of 25-50%. Inspite of the dominance in the fixed-line market by CT (south China) and CU (in north China), CM is rapidly building its nationwide presence in the fixed-line business.

Figure 1: Market leaders' mobile subs market share



Source: Company, CSCI Research estimates

Figure 2: CM mobile subs market share



Source: Company, CSCI Research

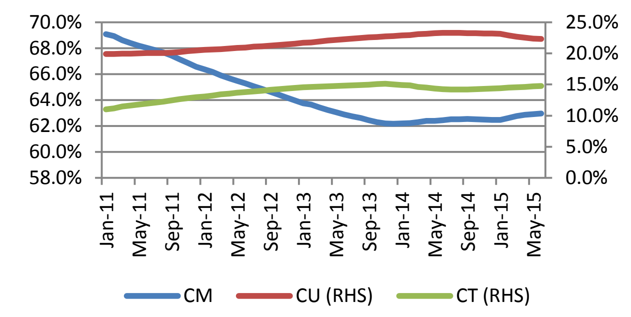
LTE likely to have led to market imbalance

To support the development of TD-LTE (which has been submitted to ITU by China as a global 4G standard), China granted the TD-LTE licenses to the telcos but postponed the issuance of the globally more popular FDD LTE licenses. Having been struggling with the 3G TD-SCDMA (due to technology drawback), CM was able to jump from 2G to 4G by reutilizing its investment in 3G. However, CT and CU have been holding back investments in TD-LTE as they wait for the FDD LTE licenses that give them better network upgrade path.

The delay in the FDD LTE license allows CM to be the early mover in 4G, which has led to the development of an imbalance with CM regaining back mobile subs market share with dominance in 4G subs in particular since early 2014.

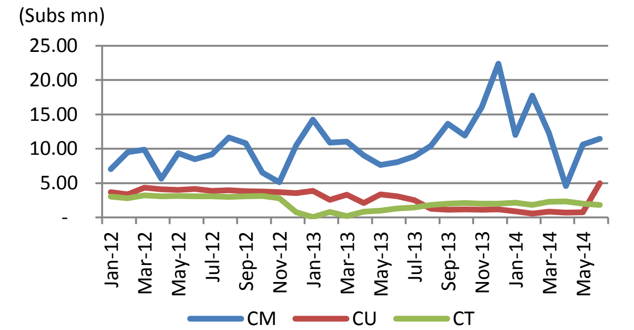
In Dec 2014, China granted the long-awaited FDD LTE licenses to CT and CU, which is one year later than the issuance of the TD-LTE licenses. As CM has built a nationwide TD-LTE network, the granting of the FDD LTE licenses to CT and CU appears not to be able to rever the industry imbalance in the near term in our view.

Figure 3: China telcos mobile subs market share



Source: Company, CSCI Research

Figure 4: China telcos 3G/4G subs monthly net adds



Source: Company, CSCI Research

Rationale for industry restructuring

Regardless of the sophistication of another industry restructuring, we see the neccessity and urgency for China to make another restructuring of the telecoms industry, which could see the merger of CT and CU along with deepening reform of mix private-state ownership.

Telecoms reform under the 'SOE reform' context

SOE reforms have increasingly become a priority among China government's policies since early 2015. While SOE reforms could come in various forms including mixed state-proviate ownership, SOE exectuive salaries system, share options for employees etc., we see consolidtion through merger to be still the main direction given the government's intension to more than halve the number of SOEs (over 100 directly controlled by central government or the SASAC).

It has been widely reported by China's offical newspapers that China government will launch a series of top-level plans for SOE reform in 2H15. Following the sucessful merger of CSR and CNR in 1H15, China may push forward for more SOE consolidation in other sectors including telecoms industry in our view.

Rationale for telecoms reform

In the past two decades, there have been a series of restructuring of the telecoms industry in China, including the latest one in 2008 when saw the merger of former China Unicom and China Netcom. The historical restructurings of the telecoms industry have been aimed at 1) reducing monopoly, 2) encouarging competition, and 3) improving efficieny. To certain extent, the last two objectives have been achieved.

However, monopoly looks to remain prominent in both the fixed line (dominated by CT in southern China and by CU in northern China) and mobile (CM holding 63% of mobile subs market share as of Jun 2015). In addition, rapid technology evolution in the telecoms industry has continued to increase telcos' capital expenditure, making the rationale for industry consolidation among smaller players. With China launching 'one belt, one road' initiative, there comes another rationale for a restructuring of the telecoms industry in China so as to make the telcos more capable of expanding its regional / global presence in our view.

Options for telecom reforms

In our view, a new round of telecoms restructuring could come in two forms. In either form, a merger between CT and CU should be the main thesis.

Option 1: merger plus deepening mix private-state ownership

In this form of restructuring, CT and CU will be merged. To reduce monopoly, the government should strengthen private sector participation in the telecoms industry by deepening private-state ownership reform.

- **Merger of CT and CU.** We see strong ground for a merger between CT and CU. With a merger, the two telecos' fixed-line business will be integrated, which would create synergies and room for prices reduction. In addition, it could substantially reduce repetitive capex in mobile networks.

- **Mix private-state ownership.** After the merger of CT and CU, there will be only two integrated telcos in China. Along with the merger of CT and CU, the government should introduce more private sector participantion by deepending mix private-state ownership reform.

Option 2: merger plus establishment of new telco

Along with a merger of CT and CU, the government could build a new telco by granting full telecos licenses to newly established 'China Broadcast and Television Netowrk Corporation' (CBTN). The CBTN has been established to push forward the development of 'tri-network' convergence.

Operating synergies from a merger

While a merger of CT and CU could pose bigger threats to CM's dominance in mobile market, we see more healthy develoment for the whole telecoms industry in China in the long run. With a merger of CT and CU, there could be substantial amount of synergies and costs savings in our estimates.

- **Capex savings.** A merger of CT and CU could reduce total capex by 20-30% in our estimates, given that much of the two telcos' current capex is in the mobile networks that are pretty much overlapped.

- **Operating costs savings.** Without the need of reduction in employees, the merged group could reduce sales and distribution networks. We estimate that 50-70% of the two telcos' retail outlets are located very close to each other.

- **Room for tariffs reduciton.** With enhanced operation efficiency and capex savings, there could be more room for telcos to reduce telecoms tariffs in our view.

Figure 5: Regional telcos valuation table

Company	Ticker	Ccy	Close (Local$)	Mkt cap (US$bn)	Fiscal Y/E	Rept'g Ccy	EPS Growth (%) FY1	EPS Growth (%) FY2	ROE (%) FY1	ROE (%) FY2	Net debt / EBITDA (x) FY1	Net debt / EBITDA (x) FY2	Net debt / Equity (%) FY1	Net debt / Equity (%) FY2	PER (x) FY1	PER (x) FY2	EV/EBITDA (x) FY1	EV/EBITDA (x) FY2	PBR (x) FY1	PBR (x) FY2	Yield (%) FY1	Yield (%) FY2
China																						
CHINA TELECOM-H	728 HK	HKD	4.30	44.9	Dec	CNY	3.2	12.3	6.2	6.7	1.1	1.1	34.8	35.3	15.2	13.6	3.9	3.8	0.9	0.9	2.2	2.5
CHINA UNICOM	762 HK	HKD	10.56	32.6	Dec	CNY	5.2	14.3	5.4	5.9	1.4	1.4	57.4	58.6	15.8	13.8	3.4	3.3	0.9	0.8	2.4	3.0
CHINA UNITED-A	600050 CH	CNY	6.08	20.8	Dec	CNY	4.4	5.6	5.6	5.9	138.8	126.3	163.6	138.9	28.5	27.0	3.9	3.6	1.6	1.5	1.1	1.2
Hong Kong																						
HKT-SS	6823 HK	HKD	9.48	9.3	Dec	HKD	19.2	8.5	9.9	10.7	265.4	254.8	86.5	86.9	18.4	17.0	8.6	8.2	1.9	1.9	5.5	6.3
PCCW LTD	8 HK	HKD	4.45	4.3	Dec	HKD	3.1	13.4	22.9	24.8	254.9	237.9	103.1	318.1	13.3	11.7	5.5	5.1	3.0	2.8	5.6	6.5
SMARTONE TELECOM	315 HK	HKD	15.26	2.1	Jun	HKD	40.5	6.7	24.2	23.5	(9.2)	(2.9)	(7.2)	(2.2)	19.5	18.3	5.5	5.2	4.5	4.2	3.4	4.0
HUTCHTEL HK	215 HK	HKD	3.41	2.1	Dec	HKD	22.8	12.1	8.3	9.1	100.6	109.1	24.5	27.5	17.1	15.3	7.2	6.8	1.4	1.4	4.3	4.8
CITIC TELECOM	1883 HK	HKD	3.50	1.5	Dec	HKD	6.1	6.5	11.1	11.2	3.2	3.0	90.7	82.0	15.0	14.1	9.2	9.0	1.7	1.6	3.3	3.5
HKBN LTD	1310 HK	HKD	8.23	1.1	Jun	HKD	2.0	63.6	16.8	28.0	267.0	226.8	188.7	171.7	31.5	19.3	11.4	10.0	5.5	5.5	3.4	5.5
Taiwan																						
CHUNGHWA TELECOM	2412 TT	TWD	95.50	23.5	Dec	TWD	(0.2)	2.7	10.5	10.8	(29.9)	(37.1)	(6.7)	(8.4)	19.5	19.0	8.9	8.7	2.0	2.0	4.9	5.0
TAIWAN MOBILE CO	3045 TT	TWD	102.50	11.1	Dec	TWD	(4.3)	5.5	23.9	25.4	142.7	130.8	76.9	73.5	19.2	18.2	12.3	11.7	4.8	4.9	5.1	5.2
FAR EASTONE TELE	4904 TT	TWD	72.30	7.5	Dec	TWD	(0.8)	7.8	16.0	17.3	85.3	74.3	31.6	29.4	20.4	18.9	9.4	8.8	3.2	3.3	5.1	5.4
Asean																						
SINGAPORE TELECO	ST SP	SGD	4.30	50.2	Mar	SGD	3.9	2.9	15.5	15.5	143.8	162.4	29.7	31.4	18.1	17.6	15.1	15.2	2.7	2.6	4.1	4.3
STARHUB LTD	STH SP	SGD	3.93	5.0	Dec	SGD	1.9	0.5	245.0	219.9	62.4	65.4	280.0	277.4	18.3	18.2	9.8	9.6	41.8	37.8	5.1	5.2
M1 LTD	M1 SP	SGD	3.27	2.2	Dec	SGD	5.9	4.0	46.4	47.0	75.0	79.8	65.2	68.7	16.4	15.8	9.7	9.4	7.7	7.5	5.7	5.9
MAXIS BHD	MAXIS MK	MYR	6.48	12.8	Dec	MYR	0.4	7.8	41.5	46.2	179.5	171.4	174.8	168.5	25.2	23.4	13.2	12.7	10.9	11.2	4.1	4.3
TELEKOM MALAYSIA	T MK	MYR	6.55	6.5	Dec	MYR	9.3	9.7	12.4	13.6	84.5	78.0	42.3	39.9	25.4	23.1	7.4	7.1	3.2	3.1	3.7	4.0
DIGI.COM BHD	DIGI MK	MYR	5.35	10.9	Dec	MYR	2.4	3.8	289.0	291.8	21.3	25.5	84.6	96.2	20.6	19.8	13.0	12.4	56.9	54.0	4.8	5.0
TELEKOMUNIKASI	TLKM IJ	IDR	2,845.0	21.3	Dec	IDR	8.5	10.4	22.1	22.5	(1.8)	(8.4)	(1.1)	(5.1)	16.9	15.3	6.1	5.6	3.8	3.5	3.8	4.3
BHARTI AIRTEL	BHARTI IN	INR	412.65	25.8	Mar	INR	85.8	13.8	8.9	9.7	258.1	246.2	123.6	117.5	28.9	25.4	7.2	6.7	2.5	2.4	0.5	0.7
ADVANCED INFO	ADVANC TB	THB	241.00	20.5	Dec	THB	9.1	12.6	84.6	89.8	67.5	76.5	102.0	114.9	17.9	15.9	10.1	9.6	14.6	13.6	5.6	6.2
TOTAL ACCESS COM	DTAC TB	THB	70.25	4.8	Dec	THB	(22.9)	11.9	28.4	33.4	108.2	89.6	98.2	91.6	18.6	16.6	6.3	5.7	5.3	5.3	5.9	6.5
GLOBE TELECOM	GLO PM	PHP	2,500.0	7.3	Dec	PHP	22.3	6.7	29.5	30.2	141.1	134.5	105.3	101.9	20.4	19.1	8.6	7.9	6.1	5.7	3.6	4.1

Source: Bloomberg, CSCI Research estimates (for cM, CT, CU and CITIC Telecom), prices as of 28 July 2015

Company Rating Definition

The Benchmark: Hong Kong Hang Seng Index; Time Horizon: 12 months

Outperform	Relative Performance >10%
Neutral	Relative Performance is -10% to 10%
Underperform	Relative Performance <10%

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