

## Citic 1616

### Target adjusted, view unchanged

to summarize...

- Downside revision on weaker-than-expected voice traffic volume early 2010
- Mobile VAS and VPN services remain as long-term growth driver
- Strong cash flow and dividend payout ratio at 50%
- Expect further M&A to raise geographical exposure; good for cross-selling
- Maintain BUY with revised target price at HK\$2.68 per share.

#### Downward revision on weaker-than-expected voice calls volume in early 2010.

According to Ministry of Industry and Information Technology (MIIT), China outbound calls by fixed line and IP phones mounted to 907m minutes between Jan and May 2010, down 5.7% YoY from 961m minutes for the first 5 months of 2009. Including the new category of mobile IDD outbound, total voice calls outbound rose 19% YoY to 1,044m minutes for the first 5 months of 2010, slower than our original estimates. Although it is an incomplete picture of the whole IDD market in China, we revised our assumptions on top line growth of the company. Table 1 shows our revised assumptions on top line growth rates of voice services, SMS services, mobile VAS as well as data services such as VPN. Notice that we expect voice services to increase 15% in traffic volume while fall 10% in ASP in 2010 due to slowing market growth shown by MIIT data.

**Table 1. Revised top line growth rates for various segments in 2010**

HK\$m	Turnover	Growth rate	Volume	ASP
	FY12/09A	FY12/10F	component	Component
Voice services	1,726.9	3.5%	15.0%	-10.0%
SMS services	286.0	12.5%	12.5%	0.0%
Mobile VAS	112.0	17.5%	n.a.	n.a.
VPN and others	591.7	7.5%	n.a.	n.a.
<b>Total Revenue</b>	<b>2,716.6</b>	<b>0.6%</b>	<b>n.a.</b>	<b>n.a.</b>

Source: Company data, SBI E2-Capital

**Mobile VAS remains as the key growth driver.** Although revenue from mobile VAS was HK\$112m for FY12/09A, representing 4.1% revenue in the year, we believe it is the major growth driver going forward. We assume stable gross margin for these segments. In Table 2, it shows that mobile VAS and VPN services are expected to contribute the most gross profit increment for FY12/10F. With increasing penetration of 3G and smartphone, we think there is increasing demand for VAS on the customers' side and thus mobile VAS services on the operators' side. Given higher margin of mobile VAS and VPN, we believe mobile VAS and VPN services will contribute even larger share to future profit growth beyond 2010.

**Table 2. Gross profit growth breakdown**

HK\$m	Turnover	Growth rate	Gross margin	Gross profit
	FY12/09A	FY12/10F	estimate	Incremental FY12/10F
Voice services	1,726.9	3.5%	20.0%	12.1
SMS services	286.0	12.5%	35.0%	12.5
Mobile VAS	112.0	17.5%	80.0%	15.7
VPN and others	591.7	7.5%	35.0%	15.5

Source: Company data, SBI E2-Capital

<b>Ticker</b>	<b>1883 HK</b>
<b>Rating</b>	<b>BUY</b>
Price (HK\$)	2.04
Target Price (HK\$)	2.68 (+31%)
12m Price Range (HK\$)	1.22-3.00
Market cap. (US\$m)	632.6
Daily t/o (US\$m)	0.6
Free float (%)	35.0

#### Financial summary

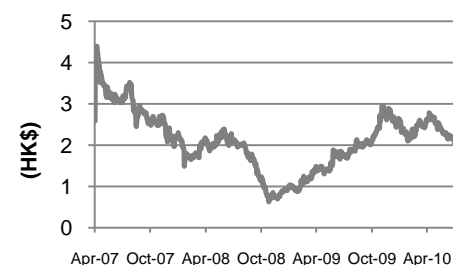
Year to Dec	08A	09A	10F	11F	12F
Turnover (HK\$m)	2,486	2,717	2,877	3,084	3,291
Net Profit (HK\$m)	332	372	458	557	591
EPS (HK\$)	0.168	0.188	0.192	0.234	0.248
P/E (x)	16.0	14.3	13.9	11.5	10.8
P/B (x)	3.5	3.1	3.4	2.7	2.3
EV/EBITDA (x)	9.2	8.3	9.7	8.3	7.1
Yield (%)	3.1	3.5	3.8	4.5	4.6
ROE (%)	23.7	23.0	25.4	26.0	22.9
ROCE (%)	26.9	27.4	25.2	23.3	20.6
N. Gear. (%)	Cash	Cash	Cash	Cash	Cash

Source: SBI/Bloomberg

	10F	11F	12F
Consensus EPS (RMB)	0.216	0.254	0.255
Previous earnings (RMBm)	552.2	666.0	-
Previous EPS (RMB)	0.232	0.279	-

#### Price performance

Year to Dec	1m	3m	12m
Relative to HSI (%)	(11.2)	(17.0)	9.2
Actual price changes (%)	(9.6)	(21.3)	19.7



Source: Bloomberg

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**Execution – Cross selling model supported by strong cash flow.** As we have always emphasized, Citic 1616 is a strong cash generator. The company expects to maintain payout ratio as high as 50%, yet the company could afford to pay HK\$467.0m cash for acquisition in 2009 and held HK\$686.2m cash at the end of 2009. To grow the business further, the company plans to leverage on its strong cash flow for M&As to 1) increase geographical exposure in Asia, US, Europe as well as South Africa and Middle East; 2) capture more corporate customers for cross selling its service portfolio of voice services, SMS services, mobile VAS and data services. Leveraging from the existing platform, operational expenses incremental is relatively limited compared to new business earned. Margin could be very high with this cross-selling model.

**Update on the last acquisition in Macau.** Citic 1616 acquired 20% of Companhia De Telecomunicacoes de Macau (CTM) by cash of HK\$467.0m and consideration shares of HK\$933.4m at price of HK\$2.30 per share. By the end of May 2010, the transaction was completed. The management indicated that CTM would contribute profit to the company for the last 7 months in 2010. CTM is engaged in fixed telephone services, telegram services, fixed telex services, fixed services for data transmission (except internet) and leased circuit services in Macau under a franchise with exclusive rights. CTM is also granted the licences from the Macau government to provide mobile services including GSM and WCDMA in competition with other operators in Macau. We think this is a typically favourable M&A for Citi1616 because of the increased geographical exposure as well as multi-segment exposure for cross-selling.

**Maintain BUY with revised target price at HK\$2.68.** We revised our sales estimate to HK\$2,876.6m for FY12/10F and HK\$3,083.9m for FY12/11F (from HK\$3,290.8m for FY12/10F and HK\$3,667.2m for FY12/11F). Net profit estimate is revised to HK\$458.1m for FY12/10F and HK\$556.8m for FY12/11F (from HK\$552.2m for FY12/10F and HK\$666.0m for FY12/11F). Based on 12% WACC, our new target price is HK\$2.68 (from HK\$3.06). Maintain BUY. Downside risks include 1) faster-than-expected traffic volume growth in China; 2) Slower-than-expected 3G penetrations in China.

**Table 3. Pro-forma profit and loss**

Year to Dec (HK\$m)	08A	09A	10F	11F	12F
Turnover	1,358.3	2,716.6	2,876.6	3,083.9	3,290.6
Other revenue	10.0	5.5	7.0	9.0	11.5
Other net (loss)/gain	(11.5)	0.5	(14.4)	(15.4)	(16.5)
Network, operations and support expenses	(916.2)	(1,801.0)	(1,901.1)	(2,044.3)	(2,178.0)
Depreciation and amortisation	(56.7)	(110.9)	(118.7)	(123.7)	(137.2)
Staff costs	(93.8)	(220.5)	(244.5)	(246.7)	(263.3)
Other operating costs	(72.0)	(141.9)	(143.8)	(154.2)	(164.5)
<b>Profit from operations</b>	<b>217.9</b>	<b>448.3</b>	<b>461.1</b>	<b>508.5</b>	<b>542.6</b>
Finance costs	(0.0)	0.0	0.0	0.0	0.0
Share of profit/(loss) in associates	(0.9)	(1.3)	84.3	154.4	164.7
<b>Profit before taxation</b>	<b>217.0</b>	<b>447.0</b>	<b>545.4</b>	<b>662.9</b>	<b>707.4</b>
Income tax	(36.0)	(75.4)	(87.3)	(106.1)	(116.7)
<b>Net Profit</b>	<b>181.0</b>	<b>371.5</b>	<b>458.1</b>	<b>556.8</b>	<b>590.6</b>

Source: Company data, SBI E2-Capital

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**BUY** : absolute upside of >10% over the next six months

**HOLD** : absolute return of -10% to +10% over the next six months

**SELL** : absolute downside of >10% over the next six months

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