

Asset-light telecom play

China Telecommunications

CITIC 1616 (1883 HK)

Not Rated

Independent service provider to telecom operators. CITIC 1616 is a spin-off listing of CITIC Pacific (267 HK) and provides connectivity services for telecom operators, with a focus on the China and Hong Kong telecommunications markets. The company acts independent of all operators to offer bulk hubbing connectivity products, which can be separated into four categories: 1) fixed-line/hybrid; 2) mobile; 3) SMS and 4) mobile value added services (VAS) and enterprise solutions.

Table 1: Offer statistics

No. of shares offered (greenshoe option: 15%)	815.9m (23.0% new shares/ 77.0% old shares)
Fund raised	HK\$1,737.9-2,105.1m
Price range	HK\$2.13-2.58
Offer P/E (FY12/06A F.D.)	22.0-26.7x
FY12/05A EPS - Basic	HK\$0.097
FY12/06A EPS - Basic	HK\$0.058
Market cap.	US\$513.4-621.8m
IPO open	22-Mar
IPO close	27-Mar
Listing	3-Apr

Source: Company data

Large customer base with main staples in China. CITIC 1616 derives a significant portion of revenue from China and counts all four major telcos among top five of its 237 customers, as of end-FY12/06A. In FY12/06A, China Mobile (941 HK) accounted for around 30% of revenues, China Telecom (728 HK) around 8%, and China Unicom (762 HK) and China Netcom (906 HK) for <5% each. SmarTone (315 HK), CITIC 1616's largest customer outside China, accounted for around 5% of revenues. The top five accounted for 47.7% of revenues in FY12/06A. The company plans to expand its customer base to around 270 by the end of FY12/07F.

Why use CITIC 1616's hubbing services? International telecom interconnections are complex and made even more so by multiple operators in one country, multiple product offerings, as well as telecommunication standards. To offer comprehensive value to their subscribers, telcos need to have full connectivity to all telco operators in other countries. While large operators, with significant inter-operator traffic volume, such as China Mobile and Verizon, may seek direct bilateral agreements, it is not cost and time efficient for them to pursue individual agreements with smaller operators. Meanwhile, small operators may have entry barriers to establish liaison with larger operators or have difficulty negotiating reasonable interconnection rates. CITIC 1616 is able to bridge this gap by establishing a neutral centralized hub, to which all telcos, large or small, can connect.

Advantages of CITIC 1616's hubbing. The company's hubbing services offer the following advantages: 1) consolidated telecom traffic volume; 2) eliminate incompatibilities in standards, protocols, language and network interfaces; 3) fast and efficient connectivity; 4) lower outgoing traffic costs; 5) additional income streams from terminal foreign operators and 6) expert and customized products to meet the demands and trends of the international telecom industry. Furthermore, this outsourcing trend is set to continue as telco operators take up CITIC 1616's offerings to: 1) allow them to focus on their core business; 2) save time and costs and 3) compensate for potential lack of international business experience.

Scale without the need for significant fixed assets. CITIC 1616's 237 strong hubbing network is able to generate significant scale for the company without the need for huge fixed-asset investments. The company

SBI E2-Capital is a dedicated small/mid cap investment banking/ stockbrokerage house. Find our research on: sbie2capital.com, thomsononeanalytics.com, factset.com and multex.com

Investors should assume that SBI E2-Capital is seeking or will seek investment banking or other primary businesses with the companies in this report.

Analyst certification: the views expressed in this report accurately reflects the analyst's personal views of the subject securities and that the analyst has not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report.

Disclaimer: the information and opinions in this report were prepared by SBI E2-Capital Securities Limited. SBI E2-Capital Securities Limited does not undertake to advise you of changes in its opinion or information. SBI E2-Capital Securities Limited and others associated with it may have positions in and effect transactions in securities of companies mentioned and may also perform or seek to perform investment banking services for those companies. This memorandum is based on information available to the public. No representation is made that it is accurate or complete. This memorandum is not an offer to buy or sell the securities mentioned.

handled around 4.2b minutes traffic in 2006, comparable with China Mobile's 6.7m minutes and exceeding Chunghwa Telecoms' 2.1b minutes. However, the company's HK\$278.1m fixed assets at the end of FY12/06A pales in comparison with China Mobile's RMB203.4b at the end of 1H FY12/06A.

Growth drivers. The growth drivers for the company are: 1) growth in China's telecom industry; 2) increasing voice, data traffic between China and the rest of the world; 3) increasing tourism into China; 4) increasing disposable income level of the Chinese leading to more travel abroad and 5) increasing use of SMS and VAS.

Benefiting only from international connectivity. Though CITIC 1616's taps China's emerging telecom industry, its business model is such that it benefits only from inbound/outbound international voice, SMS, data and/or VAS traffic. The company in general does not derive any revenue from interconnection among the four Chinese telcos, which have direct bilateral agreements with each other.

Operators are both customers and competitors. CITIC 1616 is not without competitors. Large incumbent telco operators such as China Mobile, BT, AT&T have built up a solid network of international connectivity over the years and often resell any excess capacity to third party operators. Thus telcos are often both customers and competitors of CITIC 1616. There are also companies with "similar" business models such as IDT, Comfone and iBasis.

Experienced management with strong connections. CITIC 1616 has a strong management team with extensive experience in Asia's telecom market, both at operator and regulatory levels. Chairman Shi Cuiming was Chairman and CEO of China Mobile (Hong Kong) from 1997 to 1999 as well as the former Director General of the Ministry of Posts and Telecommunications.

CITIC Pacific disposing non-core business. CITIC Pacific has indicated for some time that it would dispose of non-core assets to focus its business on specialized steel and China property, and hence, the large proportion of old shares (77%) in the share offering. After the IPO, CITIC Pacific's stake in the company will be diluted to 56.6% (50.0% including over-allotment). In effect, new funds raised by CITIC 1616 from the IPO amount to only HK\$399.7-484.2m (not including over-allotment).

Cornerstone investors to subscribe for US\$90m. Cornerstone investors, including the Government of Singapore Investment Corporation (GIC) and Ashmore Asian Recover Fund, have entered into an agreement to subscribe for an aggregate of US\$90.0m shares as part of the International Placing.

Table 2: Use of proceeds

	%
Merger & acquisition, establishment of joint venture activities	54
Upgrade hardware/software	23
New products, applications development	20
Working capital	3

Source: Company data

Table 3: Turnover breakdown

Year end Dec (HK\$m)	04A	05A	06A
Turnover			
Fixed-line/Hybrid carrier voice hubbing services	440.0	385.3	575.5
Mobile carrier voice hubbing services	503.5	478.5	566.1
SMS hubbing services	48.2	75.2	117.1
Mobile VAS and enterprise solutions	55.5	41.0	105.5
Total	1,047.2	980.0	1,364.2

Source: Company data

Table 4: Financial highlights

Year end Dec (HK\$m)	04A	05A	06A
Sales	1,047.2	980.0	1,364.2
EBITDA	169.3	179.7	292.9
Operating profit	108.7	112.2	219.9
Net profit	101.5	97.8	201.5

Source: Company data

Table 5: Margin trends (continuing operations)

Year end Dec (%)	04A	05A	06A
EBITDA	16.2	18.3	21.4
Operating	10.4	11.4	16.1
Net	8.7	9.6	13.3

Source: Company data, SBI E2-Capital

Table 6: Key ratios

Year end Dec	04A	05A	06A
Receivable days	210	104	113
Payables days	175	128	127
Current ratio (x)	1.5	2.1	1.2
Gearing (%)	Cash	Cash	Cash
ROE (%)	17.8	15.8	38.8
Debt/equity (%)	na	na	na
Interest coverage (x)	na	na	na

Source: Company data

Investment Highlights

- ❑ Continuing growth in China's emerging telecom industry.
- ❑ Increasing voice, data traffic between China and the rest of the world.
- ❑ Increasing disposable income level of the Chinese leading to more travel abroad and increasing tourism into China
- ❑ Outsourcing trend in the telecom industry.
- ❑ Increasing use of SMS and VAS.
- ❑ Large-scale telecom company with an asset-light model.

Valuation.

CITIC 1616 has not provided a profit forecast for FY12/07F. In terms of historical profit, the company's FY12/06A bottom line of HK\$201.5m represents 22.0x to 26.7x P/E. Though valuation is stretched compared with peers in similar lines of business, investors will be paying for: 1) China premium; 2) scale and 3) asset-light business model within the telecom industry.

Table 7: Peer comparisons

Stock	Ticker	Currency	Share price (HK\$)	Market cap (US\$m)	P/E (x) historical	Operating margin (%)	ROA (%)	ROE (%)
Telco operators								
China Mobile	941 HK	HKD	73.60	184,628.3	23.7	34.1	13.6	21.2
China Telecom	728 HK	HKD	3.64	37,291.0	10.5	23.0	6.7	16.4
BT	BT/A LN	GBP	303.75	48,918.5	9.0	13.5	5.9	193.4
Deutsche Telekom	DTE GR	EUR	12.53	72,648.5	17.4	8.5	2.5	6.9
SingTel	ST SP	SGD	3.22	33,528.8	11.9	21.2	12.1	20.6
<i>Average</i>					<i>14.5</i>	<i>20.1</i>	<i>8.1</i>	<i>51.7</i>
Service providers								
Belgiacom	BELG BB	EUR	34.31	16,501.8	18.8	22.4	14.8	42.2
IDT	IDT US	USD	11.56	953.8	na	na	na	na
Ibasis	IBAS US	USD	10.20	338.4	85.0	0.9	na	na
Syniverse Tech	SVR US	USD	10.83	736.8	7.5	22.9	11.5	24.3
<i>Average</i>					<i>37.1</i>	<i>15.4</i>	<i>13.2</i>	<i>33.3</i>
<i>Average (ex. Ibasis)</i>					<i>13.1</i>	<i>22.7</i>	<i>13.2</i>	<i>33.3</i>

Source: SBI E2-Capital