

## Post restructuring update

## Sector Update

### Key points:

- Uncertainties due to: 1) competition; 2) MIIT initiatives; and 3) asymmetric regulations
- Positive on China Mobile's long-term fundamentals and prospects to acquire subs, despite possible short-term volatility
- Positive on China Unicom's benefits from asymmetric regulations and ability of its mobile business to deliver growth and margin improvement
- Negative on China Telecom's 1) smaller community subscriber base; 2) narrow selection of handsets; 3) high percentage of low-end users

### China Telcos

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**Sector update.** The three telco operators have announced their 3Q earnings for the last time under their original structure. China Unicom (CU, 762 HK) completed the acquisition of China Netcom (CN) on 15 Oct 2008 (CN was delisted on the same day), while China Telecom (CT, 728 HK) acquired CU's CDMA business on 1 Oct 2008.

**China Mobile.** China Mobile (CM, 941 HK)'s revenue was up 14.2% YoY in 3Q (2Q: 16.4%, 1Q 19.7%) at RMB104.9b. EBITDA was RMB54.8b, up 10.8% YoY (2Q: 11.2%, 1Q: 22.2%) and net profit came in at RMB27.7b, up 26.3% YoY (2Q: 51.1%, 1Q: 37.2%). The numbers suggest that CM's growth has started to slow. The company added 21.5m subs in the quarter, but both ARPU and elasticity decreased. We believe that although the Olympics may have had some impact (people spending more time at home or in gatherings, using less voice calls), its MOU may be close to peaking and thus any further tariff reduction may fail to drive MOU (and voice revenue).

**China Unicom.** CU's GSM revenue rose 0.6% YoY to RMB16.0m. Net profit, excluding the sold GSM business, was down 5.9% YoY at RMB1.5b (adjusted for the derivative component of its CB in FY12/07A). We note in 3Q costs were skewed towards the GSM business. The EBITDA margin narrowed 4.0pcp to 41.4%, which was offset by an EBITDA margin expansion to 21.7% in the sold CDMA business (from 7.5% in 1H FY12/08A). Subscriber growth was in line with expectations, with 3.1m new adds. Fixed-line subscribers of the recently merged CN business, declined 1.2m to 107.3m in 3Q, while broadband subs increased by 1.5m to 24.9m (2Q: 1.7m, 1Q: 1.9m).

**China Telecom.** CT's continued to acquire broadband subs at a steady rate, with 2.2m new additions in 3Q bringing the total to 42.2m. Fixed-line sub losses were reduced to 1.9m in 3Q, from 2.3m in 2Q and 3.2m in 1Q. CT's revenue grew 0.7% YoY to RMB44.9b, EBITDA declined 1.9% YoY to RMB21.9b and net profit increased 1.3% YoY to RMB5.6b. The number of subs of its newly acquired CDMA business dropped 1.4m in 3Q to 41.7m, after growing 1.7m in 1Q and 0.4m in 2Q, due to the company's focus on restructuring.

**Regulatory developments.** We are still awaiting full details of the government's asymmetrical regulations. A new Ministry of Industry and Information Technology (MIIT) circular, effective from 1 Oct 2008, detailed some initiatives, including: 1) opening of all telecommunications tower and lines to all operators; 2) requiring operators to adjust their technologies to better suit cooperation; 3) coordination in tower construction - a telco planning to build new towers should ask other telcos whether they have any facilities to share or plan to join the construction within a period of 10 days; 4) sharing or joint construction of other facilities such as base stations and transmission lines; 5) no exclusive facility rental agreements with third parties allowed.

**Our view.** Once the restructuring is completed, we believe that investors will focus on each telco's post-restructuring metrics and operating strategies. The sector will face some uncertainties from: 1) new competition; 2) effect of MIIT initiatives; 3) asymmetric regulations, at a time when the mobile sector's growth appears to be slowing. We expect CU and CT to take "one step backward, two steps forward", with margins in their mobile businesses to contract in the near term, before expanding in the mid term.

**View on sector players.** We are still positive on CM's long-term fundamentals. The company is a mobile leader and its large sub base, operating scale and service quality will not be eroded overnight, which puts it in a good position to weather any potential irrational competition (in terms of matching any pricing set by CT and CU). In such circumstances, we believe CM will have no problem acquiring new subs. However, the company stands to be negatively affected by any asymmetric regulations. With uncertainties about how tightly regulators will enforce new policy initiatives, the counter may suffer some near-term volatility. CM is currently trading at 4.4x FY12/09F EV/EBITDA and 9.8x FY12/09F P/E, based on consensus estimates.

We are also positive on CU. Its GSM network is similar to CMs' and it should benefit more than CT from any asymmetric regulations. Since the scale of its mobile business (in absolute terms and relative to its fixed-line operations) is larger than CTs', any growth and/or margin improvement in the mobile division should have a more material impact on its P&L. At 3.6x FY12/09F EV/EBITDA and 13.0x FY12/09F P/E, the counter is trading at a higher valuation than CT, which reflects many of the advantages we have highlighted.

We are negative on CT because of its CDMA network which suffers from: 1) smaller community sub base; 2) narrow selection of handsets; 3) higher percentage of low-end users. We believe that of the three mobile operators, CT faces the most challenges in spurring growth in this segment.

**Table 1: Valuation table**

Company name	Ticker	Mkt Cap (US\$m)	Price (HK\$)	Cur Yr P/E (x)	Nxt Yr P/E (x)	Cur Yr EV/EBITDA (x)	Nxt Yr EV/EBITDA (x)	Gearing (%)	Est. Yield (%)
China Mobile	941 HK	185,589.6	67.8	11.1	9.8	4.9	4.4	Cash	4.0
China Telecom	728 HK	29,859.2	2.7	9.1	9.5	3.4	3.2	38.0	3.2
China Unicom	762 HK	31,886.3	11.0	13.8	13.0	4.2	3.6	Cash	2.5

Source: Bloomberg

**Table 2: Price movement table**

Company	Ticker	Mkt. Cap (HK\$m)	Price (HK\$)	1m price movement	3m price movement	6m price movement
China Mobile	941 HK	185,589.6	67.8	(12.1)	(35.1)	(49.6)
China Telecom	728 HK	29,859.2	2.7	(14.2)	(36.0)	(49.5)
China Unicom	762 HK	31,886.3	11.0	(1.1)	(32.3)	(35.7)

Source: Bloomberg

**Table 3: Financial summary**

Company	Description	4Q07A	1Q08A	2Q08A	3Q08A
China Mobile	Revenue (RMBb)	98.5	93.0	103.4	104.9
	YoY chg	19.1%	19.7%	16.4%	14.2%
	EBITDA (RMBb)	54.7	49.8	54.6	54.8
	YoY chg	42.5%	22.2%	11.2%	10.8%
	EBITDA margin	55.5%	53.5%	52.8%	52.3%
	Net Profit (RMBb)	27.2	24.1	30.7	27.7
	YoY chg	36.6%	37.2%	51.1%	26.3%
China Telecom	Revenue (RMBb)	43.8	43.6	45.8	44.9
	YoY chg	2.0%	1.6%	4.0%	0.7%
	EBITDA (RMBb)	19.1	22.7	21.6	21.9
	YoY chg	-1.5%	0.4%	-1.7%	-1.9%
	EBITDA margin	43.6%	51.9%	47.2%	48.7%
	Net Profit (RMBb)	5.2	6.3	5.4	5.6
	YoY chg	-3.2%	0.5%	-4.3%	1.3%
China Unicom	Revenue (RMBb)	20.5	18.7	16.4	17.3
	YoY chg	-18.3%	-21.6%	-35.1%	-30.5%
	EBITDA (RMBb)	7.9	8.4	7.5	7.2
	YoY chg	-8.9%	1.6%	-11.6%	-14.7%
	EBITDA margin	38.3%	45.1%	45.4%	41.4%
	Net Profit (RMBb)	4.2	2.0	2.4	2.6
	YoY chg	n.a.	3.1%	1313.3%	-13.8%
	Net margin	20.4%	10.8%	14.6%	14.8%

Source: Company data

Table 4: Operating metrics summary

Company	Description	4Q07A	1Q08A	2Q08A	3Q08A
China Mobile	GSM subs (m)	369.3	392.1	414.6	436.1
	Monthly net adds (m)	19.7	22.8	22.5	21.5
China Telecom	Local access lines subs (m)	220.3	217.2	214.9	213.0
	Monthly net adds (m)	(3.1)	(3.2)	(2.3)	(1.9)
	Broadband subs (m)	35.7	37.7	40.0	42.2
	Monthly net adds (m)	1.8	2.1	2.2	2.2
China Unicom	CDMA subs (m)	41.1	42.8	43.2	41.7
	Monthly net adds (m)	1.0	1.7	0.4	(1.4)
	Local access lines subs (m)	110.8	109.1	108.5	107.3
	Monthly net adds (m)	(3.9)	(1.7)	(0.6)	(1.2)
	Broadband subs (m)	19.8	21.7	23.4	24.9
	Monthly net adds (m)	1.4	1.9	1.7	1.5
	GSM subs (m)	119.2	124.2	127.6	130.7
	Monthly net adds (m)	3.3	5.0	3.4	3.1

Source: Company data

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