

VAS chain win from restructuring

Key points:

- Telecoms restructuring to benefit companies along the VAS supply chain
- Mobile services to spur earnings growth of new mobile licensees CT and CN
- CT and CN to enrich their offerings through improved VAS to better compete with CM
- Extensive room for growth of CU's VAS revenue from GSM and CDMA networks
- 3G to boost appeal of VAS through new and richer services
- Beneficiaries include integrated content providers and distributors such as A8 (800 HK), diversified SPs such as Tencent (700 HK, HK\$64.15) and TOM Online, the VAS unit of TOM Group (2383 HK, HK\$0.470) and CPs such as Phoenix TV (8002 HK, HK\$1.21).

China Telecoms

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VAS supply chain operators to benefit from telecom restructuring. Since the joint announcement by the Ministry of Information Industry, National Development and Reform Commission and Ministry of Finance on the restructuring of China's telecom sector on 24 May 2008, the investment community has focused on benefits for China Mobile (CM) (941 HK, HK\$110.40), China Telecom (CT) (728 HK, HK\$4.70), China Unicom (CU) (762 HK, HK\$13.92) and China Netcom (CN) (906 HK, HK\$20.80). However, we believe the main winners in the new operating landscape will be companies within the supply chain of value-added services (VAS) such as integrated content provider (CP) and distributor A8 (800 HK), diversified service providers (SPs) Tencent (700 HK, HK\$64.15) and TOM Online, the VAS unit of TOM Group (2383 HK, HK\$0.470) and content provider Phoenix TV (8002 HK, HK\$1.21) amongst others.

Two networks affect CU's competitiveness. Over the past few years, CM has significantly outperformed CU in terms of subscriber numbers. At end-1Q 2008, CM had 70.1% of China's mobile subscribers, up from 68.3% a year ago. Meanwhile, CU's GSM share dropped to 22.2% and CDMA share to 7.7% in 1Q 2008, from 23.6% and 8.1%, respectively, in 1Q 2007, due to CM's better service quality and broader network coverage (including rural areas) and CU's need to operate two networks (CDMA and GSM) simultaneously, which compete for the company's capital resources.

Restructuring casts a shadow over CU's growth. In our view, this imbalance was exacerbated by the industry's imminent restructuring, which is expected to affect CU much more than CM. We believe that this uncertainty affected CU's development strategies in terms of network investment and service offerings. In contrast, CM has been very aggressive in developing its rural coverage and expanding mobile services through alliances with various CPs and SPs.

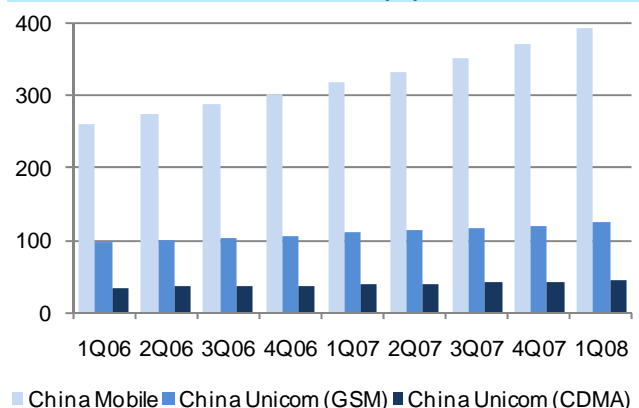
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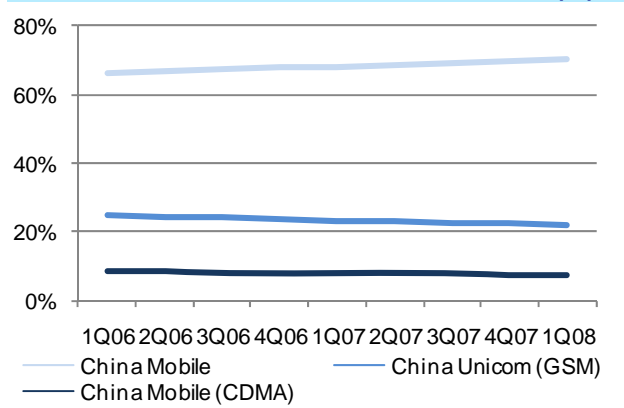
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Chart 1: China's mobile subs (m)



Source: Company data

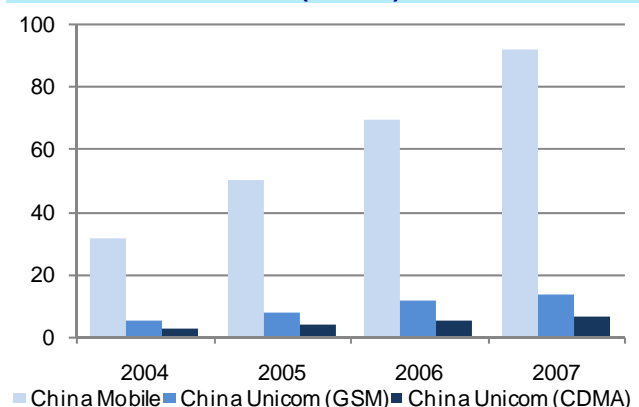
Chart 2: China's mobile subs market share (%)



Source: Company data

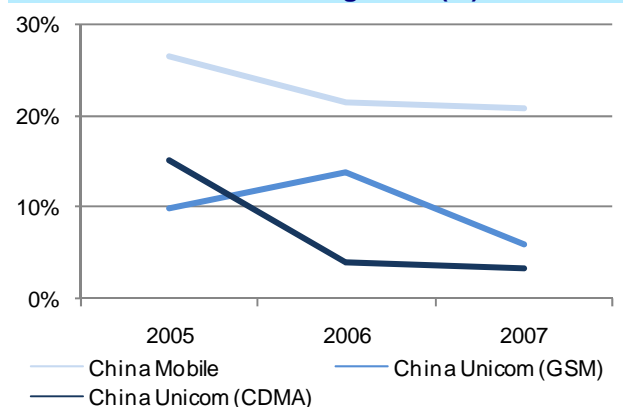
CU's VAS revenue trails CM. With poorer service offerings, CU's average revenue per user (ARPU) was RMB46 (GSM) and RMB58 (CDMA), significantly lower than CM's RMB89 at the end of 2008. Not surprisingly, CU's VAS revenue growth significantly lags that of CM.

Chart 3: VAS revenues (RMBm)



Source: Company data

Chart 4: YoY VAS revenue growth (%)



Source: Company data

New mobile carriers to help improve CU's performance. While the number of distribution channels post-restructuring will remain the same (i.e. three networks), we believe that a higher number of mobile licensees will benefit companies along the VAS supply chain, offering advantages such as:

- ❑ No conflict of interest - CT and CN will operate one mobile network each avoiding difficulties in identifying investment priorities between networks faced by CU.
- ❑ Focused investment - CT and CN both regard mobile services as the key factor in re-accelerating their earnings growth.
- ❑ Regulatory aid – as the Chinese government moves to create a more level playing field for mobile licensees, its asymmetric regulations will help CT and CN improve their competitiveness.
- ❑ Lower revenue concentration risks from CM thanks to a more balanced competitive landscape.

New services. We expect CT and CN to step up their subscriber acquisition efforts. While some price competition is inevitable, we believe the two will focus on enriching their VAS portfolios to improve user experience and drive data revenue. Asymmetric regulations may also indirectly benefit the VAS supply chain as the likely adoption of inter-network roaming will reduce the need to spend aggressively on network build out post-restructuring and allow CT and CN to concentrate on new services, such as those related to VAS.

3G to further increase VAS appeal. According to the joint policy announcement of the MII, NDRC and MOF, 3G licenses will be issued after the completion of the restructuring, likely at end-2008, in our view. The 3G network, with high download speeds allowing consumption of richer media (download and streaming of

full-track music and videos), will provide a boost to the VAS industry. All three mobile carriers are expected to receive 3G licences and benefit from the increased appeal of VAS.

Summary. In summary, the VAS chain will benefit of the sector's restructuring because of: 1) increase of addressable clients (CT and CN); 2) new mobile licensees' efforts to improve their service offerings through richer VAS; 3) lower revenue concentration risks and a more balanced competitive landscape and 4) 3G's boost of VAS appeal to mobile users.