

# China Unicom (762 HK)

## Underweight

Target price (HKD)	10.30
Share price (HKD)	12.38
Potential return (%)	-16.8

Note: Potential return equals the percentage difference between the current share price and the target price

Dec	2014 a	2015 e	2016 e
HSBC EPS	0.51	0.60	0.69
HSBC PE	19.6	16.6	14.5
<b>Performance</b>	<b>1M</b>	<b>3M</b>	<b>12M</b>
Absolute (%)	3.7	10.5	18.6
Relative <sup>A</sup> (%)	-0.1	0.1	-5.3

Note: (V) = volatile (please see disclosure appendix)

4 March 2015

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UW: Limited visibility, sales and margins under pressure

- ▶ **Unicom 4Q 2014 results missed consensus estimates, and management provided little clarity on the 2015 outlook**
- ▶ **We expect net addition growth to slow, and margins to remain under pressure from growth in network and labour costs**
- ▶ **Remain Underweight: lower EBITDA offset by reduction in long-term selling costs – no change in our DCF-derived target price of HKD10.30**

**Unicom 4Q 2014 EBITDA missed consensus estimates by 7%.** 4Q 2014 sales were up q-o-q, but fell 7.4% y-o-y due to the impact of the change from business to VAT tax, and continued reduction in handset subsidies. 4Q 2014 operating costs were down 11.5% with declines across the board except network operations and support – where we expect costs to continue to rise with the rollout of 4G.

**Capex to go up 18% to RMB100bn in 2015, as Unicom expands its broadband networks.** The company has c10% 4G penetration in the 56 cities where it currently operates, and continues to focus on a ‘mobile broadband’ proposition that includes both 3G and 4G. It declined to give guidance for either revenue growth or selling expenses, but acknowledged that industry sales growth was slowing, while margins would remain under pressure from continued growth in network operating costs. It plans an aggressive migration of 2G customers to 3G and 4G networks (we forecast 97m by end 2015e), with net additions similar to the 18m recorded in 2014.

**Raise sales estimates slightly, trim EBITDA; no change to DCF-derived target price of HKD10.30.** Our 2015e sales estimates rise by 0.6%, but we trim EBITDA by 1%, reflecting increasing cost pressure. Our 2015 sales and EBITDA estimates are both 2% below consensus estimates. We roll forward our DCF start year to 2015, and reduce our out-year selling costs forecast slightly, offsetting near-term reductions in our EBITDA forecast in our DCF. Unicom stock trades at 3.6x 2015e EBITDA, and 16.6x 2015e EPS.

**Remain cautious on fundamental outlook.** We see Unicom as relatively poorly positioned in a sector where structural growth is slowing. We expect Unicom to remain behind its peers with its 4G network rollout, losing the network advantage it has held for some years. Network costs will continue to increase, while favourable y-o-y comparisons for selling costs and interconnect costs will decline in 2015. The key risk to our view is industry restructuring. Management dismissed the recent rumours of industry restructuring, which remains the key risk to our view.

Index <sup>A</sup>	HSCEI
Index level	12,214
RIC	0762.HK
Bloomberg	762 HK

Source: HSBC

Enterprise value (CNYm)	354036
Free float (%)	78
Market cap (USDm)	38,214
Market cap (HKDm)	296,464

Source: HSBC

## Financials & valuation

### Financial statements

Year to	12/2014a	12/2015e	12/2016e	12/2017e
<b>Profit &amp; loss summary (CNYm)</b>				
Revenue	284,681	288,770	297,298	307,326
EBITDA	92,771	98,362	101,234	104,650
Depreciation & amortisation	-73,868	-77,840	-78,948	-80,064
Operating profit/EBIT	18,903	20,522	22,286	24,586
Net interest	-4,334	-4,247	-4,247	-4,247
PBT	15,931	17,637	19,401	21,700
HSBC PBT	14,569	16,275	18,039	20,338
Taxation	-3,876	-3,386	-3,067	-3,458
Net profit	12,055	14,251	16,334	18,243
HSBC net profit	12,092	13,508	14,972	16,881

### Cash flow summary (CNYm)

Cash flow from operations	88,858	90,413	94,699	98,353
Capex	-84,880	-100,000	-85,512	-76,796
Cash flow from investment	-84,880	-100,000	-85,512	-76,796
Dividends	-3,785	-4,717	-5,611	-6,452
Change in net debt	-10,183	9,587	-3,575	-15,106
FCF equity	1,217	-11,568	8,143	19,804

### Balance sheet summary (CNYm)

Intangible fixed assets	2,771	2,771	2,771	2,771
Tangible fixed assets	438,321	460,481	467,045	463,777
Current assets	56,574	74,729	79,583	96,193
Cash & others	25,364	41,897	45,472	60,578
Total assets	545,072	585,387	596,806	610,147
Operating liabilities	179,226	179,170	180,706	183,028
Gross debt	136,574	162,694	162,694	162,694
Net debt	111,210	120,797	117,222	102,116
Shareholders funds	227,541	241,792	251,675	262,694
Invested capital	293,076	316,915	323,222	319,135

### Ratio, growth and per share analysis

Year to	12/2014a	12/2015e	12/2016e	12/2017e
<b>Y-o-y % change</b>				
Revenue	-3.5	1.4	3.0	3.4
EBITDA	10.5	6.0	2.9	3.4
Operating profit	19.9	8.6	8.6	10.3
PBT	16.2	10.7	10.0	11.9
HSBC EPS	16.2	18.2	14.6	11.7

### Ratios (%)

Revenue/IC (x)	1.0	0.9	0.9	1.0
ROIC	5.3	5.6	5.8	6.4
ROE	5.4	5.8	6.1	6.6
ROA	3.0	3.3	3.7	4.0
EBITDA margin	32.6	34.1	34.1	34.1
Operating profit margin	6.6	7.1	7.5	8.0
EBITDA/net interest (x)	21.4	23.2	23.8	24.6
Net debt/equity	48.9	50.0	46.6	38.9
Net debt/EBITDA (x)	1.2	1.2	1.2	1.0
CF from operations/net debt	79.9	74.8	80.8	96.3

### Per share data (CNY)

EPS reported (fully diluted)	0.51	0.60	0.69	0.77
HSBC EPS (fully diluted)	0.51	0.60	0.69	0.77
DPS	0.20	0.24	0.27	0.31
Book value	9.65	10.25	10.67	11.14

### Valuation data

Year to	12/2014a	12/2015e	12/2016e	12/2017e
EV/sales	1.2	1.2	1.2	1.1
EV/EBITDA	3.7	3.6	3.5	3.2
EV/IC	1.2	1.1	1.1	1.1
PE*	19.6	16.6	14.5	12.9
P/Book value	1.0	1.0	0.9	0.9
FCF yield (%)	0.5	-5.0	3.5	8.5
Dividend yield (%)	2.0	2.4	2.7	3.1

Note: \* = Based on HSBC EPS (fully diluted)



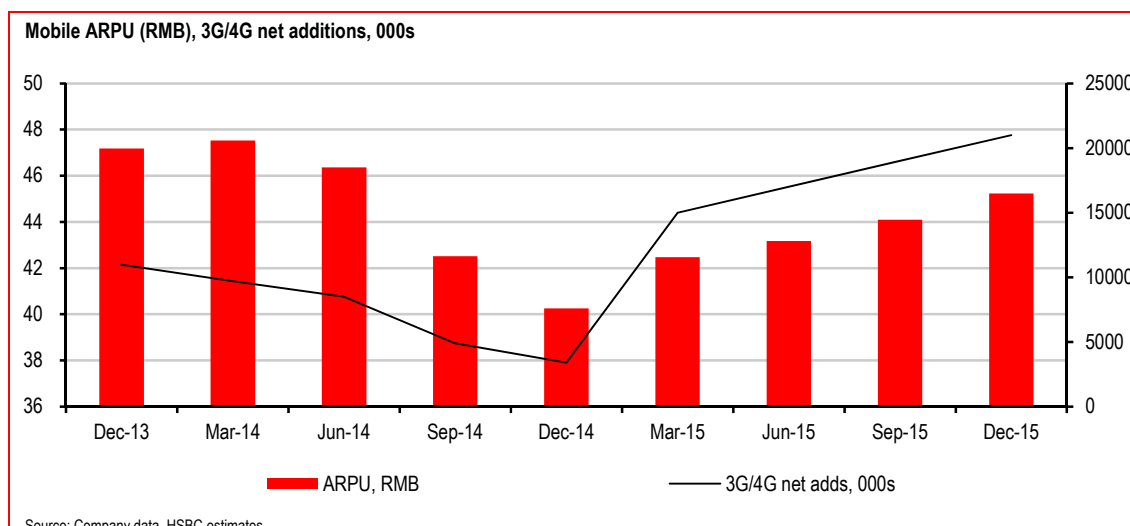
Note: price at close of 03 Mar 2015

# Valuation, rating, risks

- ▶ From network leader to laggard – 4G weakness likely to hinder operating leverage
- ▶ Tower Sharing Company progress looks slow, with minimal impact on 2015e network rollout and capex
- ▶ Remain Underweight: DCF-derived target price unchanged at HKD10.30 as we roll forward our start year to 2015 and lower out-year selling costs

## 2014 results review

China Unicom stock used to attract a premium valuation because it had the strongest technology, and thus the best subscriber and earnings momentum, offsetting its weak balance sheet. With China Mobile's launch of TD-LTE, this has changed dramatically – Unicom now has arguably the weakest technology position. To some degree this has been reflected in a de-rating of its valuation multiples – however, we expect execution to remain problematic, and see some risk of customers who bought a second SIM with Unicom (often to get an iPhone) returning to China Mobile.



## Mobile business

Mobile service revenue grew 2.6% y-o-y in 2014, and claimed a 0.4ppt increase in service revenue market share, against a backdrop of a 1.3% decline in industry revenue (according to MIIT).

- ▶ **Mobile broadband revenue** (i.e. 3G and 4G services) contributed 6.7ppt to the overall growth rate, just offsetting a 5.1ppt drag from 2G revenue decline.
- ▶ **Mobile broadband ARPU** declined from RMB75.1 in 2013 to RMB63.6 in 2014. Overall blended ARPU declined from RMB48 in 2013 to RMB44 in 2014 due to the large number of lower value 2G customers added in 1H 2014. We expect this to recover from 2015, as the impact from the change in tax regime declines.
- ▶ **Mobile broadband handset data revenue** grew by 36.8%, and increased by 5.5ppt to 39.3% of total mobile broadband service revenue.
- ▶ **Data usage per mobile broadband handset user** increased by 20.9% from 186MB per month to 224MB per month.

## Fixed line business

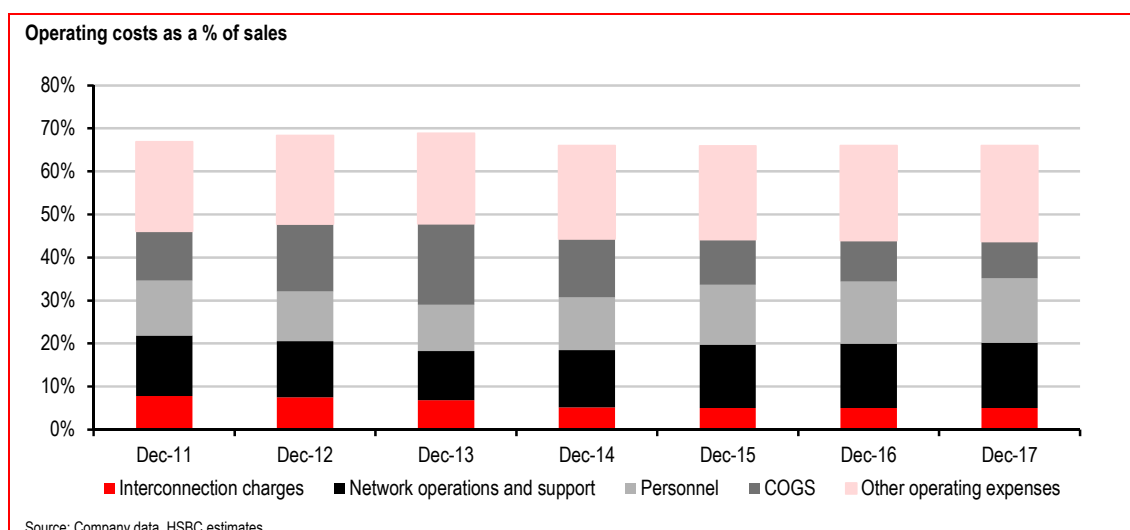
Broadband subscribers and ARPU grew steadily. Subscribers grew 6.4% from 64.647m to 68.79m, while ARPU was flattish at RMB61.4 to RMB62.2.

Overall fixed line revenue grew 2.3% y-o-y, with the contribution from broadband up 3.5ppt y-o-y.

## Operating costs

Selling and marketing costs continued to decline, down 11.7% y-o-y to RMB44.8bn. Handset subsidies declined 40.4% y-o-y to RMB4.6bn, despite an increase in 4Q 2014. The company declined to give selling expense guidance for 2015e.

- ▶ **Interconnection charges.** These were 5% of sales in 2014, declining 28% y-o-y as a result of the settlement changes introduced at the start of 2014. From 2015 onwards, the y-o-y comparisons will be less favourable – we model a 3% increase in 2015.



- ▶ **Network operations and support.** This grew 12.3% in 2014, and the company acknowledged that network costs would remain ‘under pressure’ as the network continues to expand and traffic grows. We see limited benefit from discontinuing some PSTN services, and model a 12% growth in 2015e.
- ▶ **Personnel.** We expect 16% growth relative to the 9% growth recorded in 2014.
- ▶ **Cost of Goods Sold.** We expect this to decline 21% y-o-y in line with the decline in equipment revenues.
- ▶ **Other operating expenses.** We expect this to increase 2.3% y-o-y after a relatively flat 2014, with higher selling costs from the migration to 4G.

## Network and capex

Unicom noted utilization ratios of 70% and 52% on its 2G and 3G networks respectively. With data traffic set to grow from current levels of 224MB per mobile broadband handset user per month, continued investment is necessary. The company guided that two-thirds of the RMB100bn capex budget would be spent on mobile and fixed broadband, and the remainder on transmission and IT systems. It is still auditing its assets and expects only limited activity by the Tower Sharing Company until the second half.

## Valuation, rating & risks

China Unicom shares are trading at 16.6x 2015e EPS relative to a three-year average of 17.7x forward earnings, and a one-year average of 14.6x. We continue to use a discounted cashflow valuation (DCF) for China Unicom believing that this better reflects changes in long-term cash flows.

In our DCF valuation, we apply an equity beta of 0.9, a risk-free rate of 3.5%, an equity risk premium of 7.5% and a country risk premium of 0% to derive a cost of equity of 10.3%. Our cost of debt of 5% and our debt-to-capital ratio of 30% assumptions result in a WACC of 8.3%. We apply a terminal growth rate of 1%. These inputs are unchanged, but we roll forward our DCF start year from 2014 to 2015. This results in an EV of RMB306bn, 3.2x our 2015 EBITDA estimate. This implies an unchanged target price of HKD10.30.

Under our research model, the Neutral band for non-volatile stocks runs from 5ppt below to 5ppt above the hurdle rate for Hong Kong stocks of 8.5%. Our target price implies a potential return of -16.8%, which is below the Neutral band; we therefore reiterate our Underweight rating. Potential return equals the percentage difference between the current share price and the target price, including the forecast dividend yield when indicated.

## Risks to our view

- ▶ faster revenue growth due to strong 4G adoption, elasticity of data demand and tiered data tariffs;
- ▶ lower than expected opex growth due to VAT rebates, tower sharing, and strong cost control;
- ▶ a positive financial impact of SoE reform and a change in the capital return policy.

China Unicom: HSBCe vs Consensus, prior estimates

RMBm	2013a	2014a	2015e	2016e	14-16e CAGR
<b>Consensus</b>					
Revenues	295,038	286,690	294,768	310,282	4.0%
% chg y-o-y		-2.8%	2.8%	5.3%	
Operating Expense before D&A	(210,381)	(192,459)	(194,332)	(202,812)	2.7%
% chg YoY		-8.5%	1.0%	4.4%	
EBITDA	84,657	94,231	100,437	107,470	6.8%
% chg y-o-y		11.3%	6.6%	7.0%	
% margin	28.7%	32.9%	34.1%	34.6%	
Operating Profit	16,461	20,601	23,082	26,321	13.0%
% chg y-o-y		25.2%	12.0%	14.0%	
% margin	5.6%	7.2%	7.8%	8.5%	
Net Income	10,408	12,921	14,885	17,734	17.2%
% chg y-o-y		24.1%	15.2%	19.1%	
EPS, RMB	0.44	0.54	0.62	0.74	17.3%
<b>HSBC</b>					
Revenues	295,038	284,681	288,770	297,298	2.2%
% chg y-o-y	18.5%	-3.5%	1.4%	3.0%	
Operating Expense	(211,075)	(191,910)	(190,408)	(196,064)	
% chg YoY		-9.1%	-0.8%	3.0%	
EBITDA	83,963	92,771	98,362	101,234	4.5%
% chg y-o-y	15.6%	10.5%	6.0%	2.9%	
% margin	28.5%	32.6%	34.1%	34.1%	
Operating Profit	15,767	18,903	20,522	22,286	9.2%
% chg y-o-y	35.9%	19.9%	8.6%	8.6%	
% margin	5.3%	6.6%	7.1%	7.5%	
Net Income	10,408	12,055	14,251	16,334	16.4%
% chg y-o-y	46.7%	15.8%	18.2%	14.6%	
EPS, RMB	0.44	0.51	0.60	0.69	16.5%
<b>HSBC vs. Consensus</b>					
Sales	0.0%	-0.7%	-2.0%	-4.2%	
EBITDA	-0.8%	-1.5%	-2.1%	-5.8%	
OP	-4.2%	-8.2%	-11.1%	-15.3%	
Net Income	0.0%	-6.7%	-4.3%	-7.9%	
EPS	0.0%	-5.3%	-2.4%	-6.5%	
<b>HSBC prior estimates</b>					
Sales	295,038	285,619	286,925	293,245	
EBITDA	83,963	95,597	99,153	107,954	
OP	15,767	21,863	23,942	28,805	
Net Income	10,408	13,582	14,361	20,382	
EPS, RMB	0.44	0.58	0.61	0.86	
<b>HSBC vs. previous</b>					
Sales	2013a	2014a	2015e	2016e	
		-0.3%	0.6%	1.4%	
EBITDA		-3.0%	-0.8%	-6.2%	
OP		-13.5%	-14.3%	-22.6%	
Net Income		-11.2%	-0.8%	-19.9%	
EPS		-11.5%	-0.9%	-19.9%	

Source: Company data, HSBC estimates, Bloomberg

## Changes to our estimates

We raise our revenue estimates slightly for China Unicom (1.4% in 2016e). However, we reduce our EBITDA forecasts by 0.8% in 2015e and 6.2% in 2016e, reflecting increased pressure on margins from network operating costs. This is offset in our DCF by rolling forward our start year to 2015, and lowering out-year selling costs. Changes to our estimates are outlined in the table below.

# Disclosure appendix

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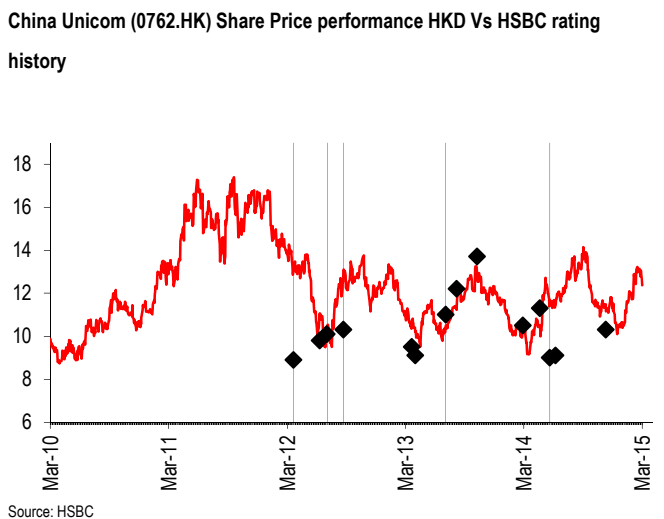
\*A stock will be classified as volatile if its historical volatility has exceeded 40%, if the stock has been listed for less than 12 months (unless it is in an industry or sector where volatility is low) or if the analyst expects significant volatility. However, stocks which we do not consider volatile may in fact also behave in such a way. Historical volatility is defined as the past month's average of the daily 365-day moving average volatilities. In order to avoid misleadingly frequent changes in rating, however, volatility has to move 2.5 percentage points past the 40% benchmark in either direction for a stock's status to change.

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<b>Underweight (Sell)</b>	19%	(20% of these provided with Investment Banking Services)

## Share price and rating changes for long-term investment opportunities



### Recommendation & price target history

From	To	Date
Neutral	Underweight	22 March 2012
Underweight	Neutral	03 July 2012
Neutral	Underweight	23 August 2012
Underweight	Neutral	05 July 2013
Neutral	Underweight	22 May 2014
Target Price	Value	Date
Price 1	8.90	22 March 2012
Price 2	9.80	11 June 2012
Price 3	10.10	03 July 2012
Price 4	10.30	23 August 2012
Price 5	9.50	22 March 2013
Price 6	9.10	02 April 2013
Price 7	11.00	05 July 2013
Price 8	12.20	08 August 2013
Price 9	13.70	10 October 2013
Price 10	10.50	28 February 2014
Price 11	11.30	21 April 2014
Price 12	9.00	22 May 2014
Price 13	9.10	09 June 2014
Price 14	10.30	11 November 2014

Source: HSBC



## HSBC & Analyst disclosures

### Disclosure checklist

Company	Ticker	Recent price	Price Date	Disclosure
CHINA UNICOM	0762.HK	12.38	03-Mar-2015	6, 7, 11

Source: HSBC

- 1 HSBC has managed or co-managed a public offering of securities for this company within the past 12 months.
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