

# China Telecom Corp (728 HK)

## Neutral

Target price (HKD)	5.40
Share price (HKD)	4.83
Potential return (%)	11.8

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	0.22	0.27	0.28
HSBC PE	17.5	14.4	13.7
<b>Performance</b>	<b>1M</b>	<b>3M</b>	<b>12M</b>
Absolute (%)	-2.9	7.7	49.7
Relative <sup>A</sup> (%)	-1.5	2.5	18.0

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

18 March 2015

**Neale Anderson\***

Analyst  
The Hong Kong & Shanghai Banking Corporation Limited  
+852 2996 6716  
neale.anderson@hsbc.com.hk

**Jia Wen\***

Associate  
The Hong Kong & Shanghai Banking Corporation Limited  
+852 2822 4686  
Jia.wen@hsbc.com.hk

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This report must be read with the disclosures and the analyst certifications in the Disclosure appendix, and with the Disclaimer, which forms part of it

N: large increase in 4G capex, monetization uncertain

- ▶ **FY14 sales were in-line with expectations, but EPS missed by 2.8% on higher network costs than expected**
- ▶ **Mobile capex to more than double in 2015e, with Telecom continuing to focus on 4G rollout in the top 120 cities**
- ▶ **Neutral: trim DCF-derived target price by 2% to HKD5.40**

### China Telecom 2014 sales were in-line, but EPS missed on higher network costs.

2014 sales of RMB324.4bn were in-line with expectations, but EPS missed by 2.8% on a 29% increase in network operations and support. DPS was HKD0.095, flat YoY.

Otherwise cost control was solid, with declines in all areas except personnel (up 8.4% YoY). 4G ARPU on c7m subscribers at end 2014 was cRMB90.

### Capex to go up 18% to RMB100bn in 2015, as Unicom expands its broadband networks.

Capex of RMB76.9bn was lower than guidance of RMB80bn, but this is forecast to jump 40% in 2015e, with spending on the mobile network more than doubling to RMB63bn. This includes a cRMB6bn contingency budget for tower construction in the event that tower sharing starts later than expected. With both Unicom and Telecom rolling out 4G at high-speed, the delay in tower sharing company is less than ideal for both companies.

### Raise sales estimates slightly, but cut DCF-derived target price by 2% to HKD5.40 (from HKD5.50) on higher capex than forecast.

Our 2015e sales estimates rise by 1%, but we trim EBITDA by 1.5%, reflecting increasing cost pressure. Our 2015 sales and EBITDA estimates are 1% below and above consensus estimates respectively. We roll forward our DCF start year to 2015, and increase our capex estimates, offsetting higher EBITDA forecasts in 2016 and 2017 in our DCF. Telecom stock trades at 4x 2015e EBITDA, and 14.4x 2015e EPS.

**Remain cautious on outlook.** China Telecom – as at Unicom two weeks ago – announced sharp increases in 4G capex and network operating costs. Yet there was relatively little guidance on the revenue and profit impact of the accelerated investment in 4G. China Telecom expects to have c60% of its mobile subscribers on 4G by end 2016, a similar proportion to those currently on 3G. We believe this will be beneficial to users (and the economy) but – against a backdrop of higher capex and network operating costs – remain cautious on the benefit to investors.

Index <sup>A</sup>	HSCEI
Index level	11,838
RIC	0728.HK
Bloomberg	728 HK

Source: HSBC

Enterprise value (CNYm)	410061
Free float (%)	78
Market cap (USDm)	49,616
Market cap (HKDm)	385,238

Source: HSBC

## Financials & valuation

### Financial statements

Year to	12/2014a	12/2015e	12/2016e	12/2017e
<b>Profit &amp; loss summary (CNYm)</b>				
Revenue	324,394	331,721	348,740	367,521
EBITDA	94,853	103,500	109,738	114,525
Depreciation & amortisation	-66,345	-69,244	-72,015	-74,583
Operating profit/EBIT	28,508	34,256	37,724	39,942
Net interest	-5,285	-5,224	-5,224	-5,224
PBT	23,257	29,032	32,550	34,768
HSBC PBT	23,257	29,032	32,500	34,718
Taxation	-5,498	-7,351	-9,750	-10,416
Net profit	17,680	21,553	22,672	24,225
HSBC net profit	16,201	20,195	22,622	24,175

### Cash flow summary (CNYm)

Cash flow from operations	83,094	91,575	96,694	99,269
Capex	-76,889	-107,800	-104,622	-101,803
Cash flow from investment	-76,889	-107,800	-104,622	-101,803
Dividends	-6,085	-6,085	-6,897	-7,935
Change in net debt	-6,858	16,225	14,825	10,470
FCF equity	7,684	-14,866	-10,377	-3,250

### Balance sheet summary (CNYm)

Intangible fixed assets	38,901	38,901	38,901	38,901
Tangible fixed assets	426,057	464,613	497,220	524,440
Current assets	59,543	52,005	54,558	57,375
Cash & others	21,815	15,000	15,000	15,000
Total assets	561,274	592,292	627,452	657,490
Operating liabilities	162,267	162,194	167,664	171,357
Gross debt	106,976	116,386	131,211	141,681
Net debt	85,161	101,386	116,211	126,681
Shareholders funds	289,183	310,736	325,473	341,219
Invested capital	340,419	378,325	408,015	434,359

### Ratio, growth and per share analysis

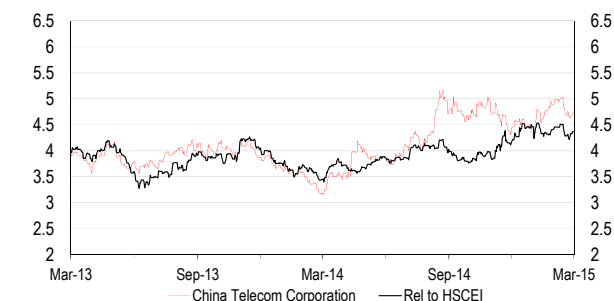
Year to	12/2014a	12/2015e	12/2016e	12/2017e
<b>Y-o-y % change</b>				
Revenue	0.9	2.3	5.1	5.4
EBITDA	-1.8	9.1	6.0	4.4
Operating profit	3.8	20.2	10.1	5.9
PBT	0.7	24.8	12.1	6.8
HSBC EPS	0.8	21.9	5.2	6.8
<b>Ratios (%)</b>				
Revenue/IC (x)	1.0	0.9	0.9	0.9
ROIC	5.9	6.7	6.7	6.6
ROE	5.7	6.7	7.1	7.3
ROA	3.9	4.4	4.4	4.5
EBITDA margin	29.2	31.2	31.5	31.2
Operating profit margin	8.8	10.3	10.8	10.9
EBITDA/net interest (x)	17.9	19.8	21.0	21.9
Net debt/equity	29.4	32.5	35.6	37.0
Net debt/EBITDA (x)	0.9	1.0	1.1	1.1
CF from operations/net debt	97.6	90.3	83.2	78.4
<b>Per share data (CNY)</b>				
EPS reported (fully diluted)	0.22	0.27	0.28	0.30
HSBC EPS (fully diluted)	0.22	0.27	0.28	0.30
DPS	0.08	0.09	0.10	0.10
Book value	3.57	3.84	4.02	4.22

### Valuation data

Year to	12/2014a	12/2015e	12/2016e	12/2017e
EV/sales	1.2	1.2	1.2	1.2
EV/EBITDA	4.2	4.0	3.9	3.8
EV/IC	1.2	1.1	1.0	1.0
PE*	17.5	14.4	13.7	12.8
P/Book value	1.1	1.0	1.0	0.9
FCF yield (%)	2.5	-4.8	-3.4	-1.1
Dividend yield (%)	2.0	2.2	2.6	2.7

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

### Price relative



Source: HSBC

Note: price at close of 18 Mar 2015

# Valuation, rating, risks

- ▶ Solid cost control in all areas except personnel (up 8% YoY) and network operations & support (up 29% YoY)
- ▶ Expect slower growth in wireline due to higher competition
- ▶ Neutral: trim DCF derived target price by 2% to HKD5.40

## Results review

### Impact of the change from the business tax to VAT

The impact of the change in tax regime was significant in 2014. China Telecom providers more disclosure than its peers on pro-forma results, making comparisons easier:

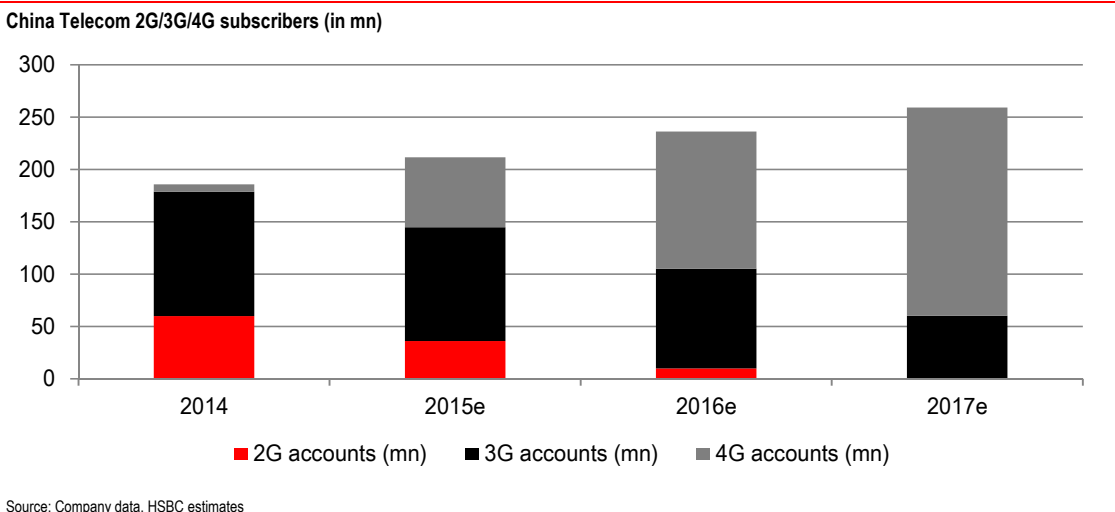
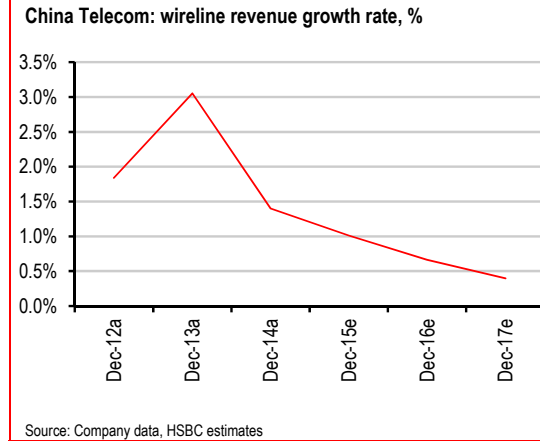
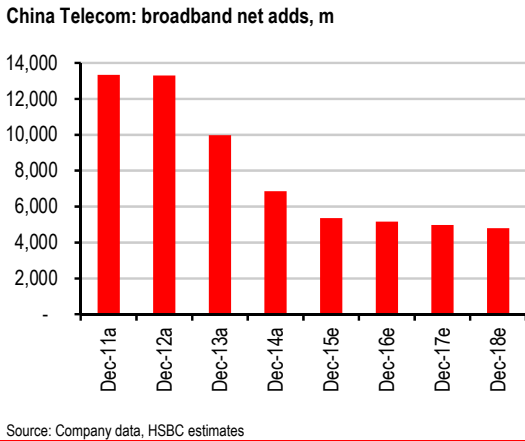
- ▶ **Revenues.** Reported total revenue growth of 0.9% was 3.8% on a pro-forma basis, with reported service revenue growth of 3.1% translating to 6.3% growth on a pro-forma basis.
- ▶ **Profit.** Reported operating profit growth of 3.8% compared to 22% on a pro-forma basis, and reported net income growth of 0.8% compared to 22.5% on a pro-forma basis.

Comparable figures based entirely on the value-added tax regime will not be available until 2H15, and even then comparisons will be difficult due to the slow speed at which the VAT credit system was set up.

### Mobile business

Mobile service revenue grew 5.7% in 2014, with 18.1% growth in data offsetting a 6.1% decline in voice revenue. Sales of terminals declined 16% as expected on lower subsidies (down 32.7% YoY in 2014).

- ▶ **4G subscribers.** 4G subscribers were c7m at end 2014, from c2m at September 2014. The company targets c60m 4G subscribers by end 2016, with a majority of customers on 4G by the end of 2016. This implies a two year migration in 4G to get to the same situation as at end 2014, which saw 64% of subscribers on 3G or 4G.
- ▶ **4G ARPU.** 4G ARPU was cRMB90 at end 2014, somewhat lower than expected. Overall mobile ARPU declined to RMB54 in 2014, from RMB54.8 in 2013. By contrast, mobile broadband ARPU (ie 3G and 4G) at China Unicom was RMB64 in 2014.



- **Data usage.** China Telecom saw relatively slow growth in average monthly data usage by 3/4G handset users, growing 19.5% from 190MB in 2013 to 227MB in 2014. Handset internet access revenue grew 48.8% YoY, but from a relatively small base of RMB22.9bn in 2013, to RMB34bn in 2014.

### Wireline business

China Telecom is seeing increasing pressure from other broadband service providers, including China Mobile. This is resulting in a slow-down in the rate of growth in the broadband business, with the company adding 6.8m subscribers in 2014, down from 10m in 2013 (chart above left). Overall, data revenue growth of 5.4% just offset a 13.1% YoY decline in voice revenue, with strong growth in wireline value-added services and integrated information services (up 11% YoY). Overall wireline service revenues grew 1.4% in 2014.

### Operating costs

As at China Unicom, Telecom saw declines in most cost lines, but a big jump in network operating costs. We expect this to continue to increase in 2015, reflecting the large increase in 4G network rollout.

Selling and marketing costs continued to decline, down 11.7% YoY (the same as Unicom) to RMB62.7bn. Handset subsidies declined 32.7% (relative to a 40.4% YoY decline at Unicom) to RMB15.3bn. The company expects a similar decline in SG&A in 2015e.

- ▶ **Interconnection charges.** These declined 13.2% YoY as a result of the settlement changes introduced at the start of 2014. From 2015 onwards, the YoY comparisons will be less favourable – we model a 2% increase in 2015.
- ▶ **Network operations and support.** This grew 29.3% in 2014 (compared to 12.3% growth at Unicom), and we expect continued rise in costs as the 4G network continues to expand and traffic grows. We model 6% growth in 2015.
- ▶ **Personnel.** We expect 9% growth relative to the 8.4% growth recorded in 2014.
- ▶ **Cost of Goods Sold.** We expect this to decline 21% YoY in line with the decline in equipment revenues.
- ▶ **Depreciation & Amortization.** This declined 4% in 2014, but the substantial increase in capex in 2015 suggests rising depreciation in 2015 – we model 4% growth.

## Network and capex – will the tower sharing company be too late?

China Telecom guided for a 40% increase in capex in 2015 to RMB107.8bn, substantially higher than the RMB90.4bn we had forecast:

- ▶ **Capex split.** Telecom plans to more than double spending on mobile to RMB63bn (from RMB30bn in 2014) in 2015, with wireline capex down slightly to RMB44.8bn, from RMB47.3bn in 2014.
- ▶ **Mobile coverage.** China Telecom aims to rollout ‘in-depth’ LTE coverage to 120 cities, noting that this would cover c75% of the current network traffic of the company. It aims to have 320k 4G base stations by end 2015 (up 200k YoY) and 140k indoor radio systems (up 80k YoY).
- ▶ **Tower sharing.** It has a cRMB6bn contingency fund in its budget for tower construction in the event that the tower sharing company is slower than expected to begin operations. It provided no material update on the progress of tower sharing at the briefing.

## Valuation, rating, risks

China Telecom shares are trading at 14.4x 2015e EPS relative to a four-year average of 16.1x forward earnings.

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% and a country risk premium of 0% to derive a cost of equity of 9.9%. Our cost of debt of 5% and our debt-to-capital ratio of 30% assumptions result in a WACC of 8%. We apply a terminal growth rate of 1%. This results in an EV of RMB405bn, 3.9x our 2015e EBITDA estimate. This implies a new target price of HKD5.40, 2% lower than our previous target price of HKD5.50.

Under our research model, the Neutral band for non-volatile stocks runs from 5ppt below to 5ppt above the hurdle rate set by our Global Equity Strategy team (9% for China). Our target price implies a potential return of 11.8%, which is within the Neutral band; we therefore reiterate our Neutral 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

Upside (downside) risks to our view are (1) faster (slower) revenue growth than expected due to strong 4G adoption, elasticity of data demand and tiered data tariffs; (2) lower (higher) opex growth than expected due to (despite) VAT rebates, and strong cost control; and (3) a positive (negative) financial impact of SoE reform and a change in the capital return policy.

## Forecasts versus prior estimates

We raise our sales estimates on slightly higher mobile data forecasts, but cut 2015e EBITDA on higher network costs than previously forecast. We raise 2016 and 2017e EBITDA on lower selling costs than previously forecast.

### China Telecom: HSBCe vs consensus, prior estimates

RMBm	2015e	2016e	2017e	13-16e CAGR
<b>Consensus</b>				
Revenues	334,691	353,189	372,823	3.2%
% chg YoY	3.2%	5.5%	5.6%	
Operating Expense	(231,798)	(242,368)	(250,351)	2.5%
% chg YoY	2.1%	4.6%	3.3%	
EBITDA	102,892	110,821	122,472	4.7%
% chg YoY	5.6%	7.7%	10.5%	
% margin	30.7%	31.4%	32.8%	
Operating Profit	32,793	37,114	41,965	10.6%
% chg YoY	9.2%	13.2%	13.1%	
% margin	9.8%	10.5%	11.3%	
Net Income	20,445	23,449	29,744	10.2%
% chg YoY	11.7%	14.7%	26.8%	
EPS, RMB	0.25	0.29	0.38	9.4%
<b>HSBC</b>				
Revenues	331,721	348,740	367,521	2.7%
% chg YoY	2.3%	5.1%	5.4%	
Operating Expense	(228,221)	(239,002)	(252,996)	
% chg YoY	-0.6%	4.7%	5.9%	
EBITDA	103,500	109,738	114,525	4.4%
% chg YoY	9.1%	6.0%	4.4%	
% margin	31.2%	31.5%	31.2%	
Operating Profit	34,256	37,724	39,942	11.2%
% chg YoY	20.2%	10.1%	5.9%	
% margin	10.3%	10.8%	10.9%	
Net Income	21,553	22,672	24,225	8.9%
% chg YoY	21.9%	5.2%	6.8%	
EPS, RMB	0.27	0.28	0.30	8.9%
<b>HSBC vs. Consensus</b>				
Sales	-0.9%	-1.3%	-1.4%	
EBITDA	0.6%	-1.0%	-6.5%	
OP	4.5%	1.6%	-4.8%	
Net Income	5.4%	-3.3%	-18.6%	
EPS	5.3%	-2.7%	-21.2%	
<b>HSBC Nov 2014 estimates</b>				
Sales	328,577	341,088	353,880	
EBITDA	105,035	106,969	110,224	
OP	32,762	31,567	34,235	
Net Income	19,063	18,172	20,039	
EPS, RMB	0.24	0.22	0.25	
<b>HSBC vs. previous</b>				
Sales	1.0%	2.2%	3.9%	
EBITDA	-1.5%	2.6%	3.9%	
OP	4.6%	19.5%	16.7%	
Net Income	13.1%	24.8%	20.9%	
EPS	13.1%	24.8%	20.9%	

Source: Company data, HSBC estimates, Bloomberg

# Disclosure appendix

## Analyst Certification

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Our ratings are re-calibrated against these bands at the time of any 'material change' (initiation of coverage, change of volatility status or change in price target). Notwithstanding this, and although ratings are subject to ongoing management review, expected returns will be permitted to move outside the bands as a result of normal share price fluctuations without necessarily triggering a rating change.

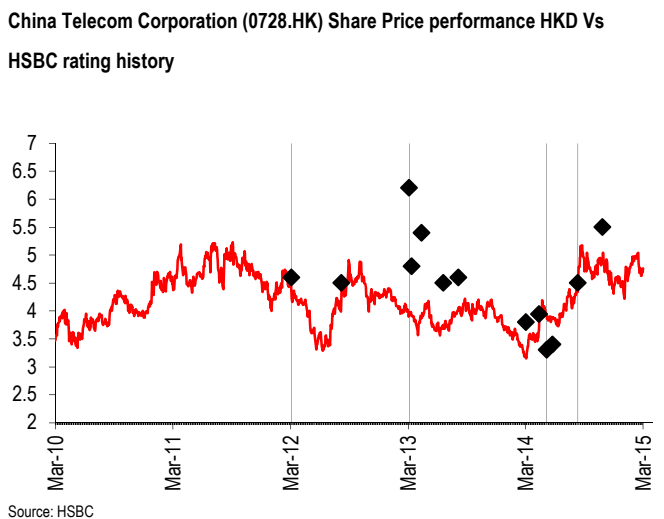
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As of 18 March 2015, the distribution of all ratings published is as follows:

<b>Overweight (Buy)</b>	41%	(30% of these provided with Investment Banking Services)
<b>Neutral (Hold)</b>	39%	(28% of these provided with Investment Banking Services)
<b>Underweight (Sell)</b>	20%	(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
Overweight	Neutral	20 March 2012
Neutral	Overweight	20 March 2013
Overweight	Underweight	22 May 2014
Underweight	Neutral	27 August 2014
Target Price	Value	Date
Price 1	4.60	20 March 2012
Price 2	4.50	22 August 2012
Price 3	6.20	20 March 2013
Price 4	4.80	28 March 2013
Price 5	5.40	28 April 2013
Price 6	4.50	05 July 2013
Price 7	4.60	21 August 2013
Price 8	3.80	19 March 2014
Price 9	3.94	28 April 2014
Price 10	3.30	22 May 2014
Price 11	3.40	09 June 2014
Price 12	4.50	27 August 2014
Price 13	5.50	11 November 2014

Source: HSBC



## HSBC & Analyst disclosures

### Disclosure checklist

Company	Ticker	Recent price	Price Date	Disclosure
CHINA TELECOM CORPORATION	0728.HK	4.76	17-Mar-2015	4, 6, 11

Source: HSBC

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**Issuer of report**

**The Hongkong and Shanghai Banking Corporation Limited**

Level 19, 1 Queen's Road Central

Hong Kong SAR

Telephone: +852 2843 9111

Fax: +852 2596 0200

Website: [www.research.hsbc.com](http://www.research.hsbc.com)

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# Global Telecoms, Media & Technology Research Team

## Global

**Stephen Howard**  
*Analyst, Global Sector Head*  
+44 20 7991 6820    stephen.howard@hsbcib.com

## Europe

**Nicolas Cote-Colisson**  
*Analyst*  
+44 20 7991 6826    nicolas.cote-colisson@hsbcib.com

**Antonin Baudry**  
*Analyst*  
+33 1 56 52 43 25    antonin.baudry@hsbc.com

**Christopher Johnen**  
*Analyst*  
+49 211 910 2852    christopher.johnen@hsbc.de

**Dominik Klarmann, CFA**  
*Analyst*  
+49 211 910 2769    dominik.klarmann@hsbc.de

**Christian Rath**  
+49 211 910 3049    christian.rath@hsbc.de

**Luigi Minerva**  
*Analyst*  
+44 20 7991 6928    luigi.minerva@hsbcib.com

**Olivier Moral**  
*Analyst*  
+33 1 5652 4322    olivier.moral@hsbc.com

**Adam Fox-Rumley**  
*Analyst*  
+44 20 7991 6819    adam.fox-rumley@hsbcib.com

**Dhiraj Saraf, CFA**  
*Analyst*  
+91 80 3001 3773    dhirajsaraf@hsbc.co.in

## Americas

**Christopher A Recouso**  
*Analyst*  
+1 212 525 2279    christopher.a.recouso@us.hsbc.com

**Sunil Rajgopal**  
*Analyst*  
+1 212 525 0267    sunilrajgopal@us.hsbc.com

## Global Emerging Markets (GEMs)

**Hervé Drouet**  
*Analyst*  
+44 20 7991 6827    herve.drouet@hsbcib.com

## Emerging Europe, Middle East & Africa (EMEA)

**Franca Di Silvestro**  
*Head of Research, SA*  
+27 11 676 4223    franca.disilvestro@za.hsbc.com

**Bülent Yurdagül**  
*Analyst*  
+90 212 376 46 12    bulentyurdagul@hsbc.com.tr

## Asia

**Yogesh Aggarwal**  
*Analyst*  
+91 22 2268 1246    yogeshaggarwal@hsbc.co.in

**Neale Anderson**  
*Analyst*  
+852 2996 6716    neale.anderson@hsbc.com.hk

**Joyce Chen**  
*Analyst*  
+8862 6631 2862    joycechen@hsbc.com.tw

**Luis Hilado**  
*Analyst*  
+65 6658 0607    luishilado@hsbc.com.sg

**Jenny Lai**  
*Head of Research, Taiwan*  
+8862 6631 2860    jennylai@hsbc.com.tw

**Lionel Lin**  
*Analyst*  
+65 6658 0624    lionelylin@hsbc.com.sg

**Carrie Liu**  
*Analyst*  
+8862 6631 2864    carriecfliu@hsbc.com.tw

**Steven C Pelayo**  
*Analyst*  
+852 2822 4391    stevenpelayo@hsbc.com.hk

**Ricky Seo**  
*Analyst*  
+822 37068777    rickyjuilseo@kr.hsbc.com

**Rajiv Sharma**  
*Analyst*  
+91 22 2268 1239    rajivsharma@hsbc.co.in

**Jerry Tsai**  
*Analyst*  
+8862 6631 2863    jerrytsai@hsbc.com.tw

**Chi Tsang**  
*Analyst*  
+852 2822 2590    chitsang@hsbc.com.hk

**Rajesh Raman**  
*Analyst*  
+65 6658 0608    rajeshraman@hsbc.com.sg

**Yolanda Wang**  
*Analyst*  
+8862 6631 2867    yolandayywang@hsbc.com.tw

**Tse-yong Yao**  
*Analyst*  
+8862 6631 2861    tse-yongyao@hsbc.com.tw

**Jena Han**  
*Analyst*  
+822 3706 8772    jenahan@kr.hsbc.com

**Will Cho**  
*Analyst*  
+822 3706 8765    will.cho@kr.hsbc.com

**Alice Cai**  
*Associate*  
+852 2996 6584    alice.y.cai@hsbc.com.hk

**Jia Wen**  
*Associate*  
+852 2822 4686    jia.wen@hsbc.com.hk

**Kenneth Shim**  
*Associate*  
+822 3706 8779    kennyshim@kr.hsbc.com

**David Huang**  
*Associate*  
+886 2 66312865    david.s.huang@hsbc.com.tw

## Specialist Sales

**Gareth Hollis**  
+44 20 7991 5124    gareth.hollis@hsbcib.com

**Kubilay Yalcin**  
+49 211 9104880    kubilay.yalcin@hsbc.de

**Myles McMahon**  
+852 2822 4676    mylesmacmahon@hsbc.com.hk