

China Telecom

728 HK

Target (HKD): 5.00 → 5.50

Upside: 13.6%

18 Mar price (HKD): 4.84

- 1 Buy
- 2 Outperform (unchanged)
- 3 Hold
- 4 Underperform
- 5 Sell

Sharpening its 4G focus

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- 4Q14 results marginally ahead of our forecasts
- Market focus likely to centre on 4G expansion plans
- Reaffirm Outperform rating with higher target price

■ What's new

The costs associated with China Telecom's 4G network expansion are likely to be a market focus on the back of its 4Q14 results. We reaffirm our Outperform (2) rating as we believe the company's ARPU (average revenue per user) guidance – YoY improvement for 2015 – suggests its confidence in monetising these investments in a relatively short time frame.

■ What's the impact

China Telecom's 4Q14 net profit beat our recently reduced forecast by 14% on slightly better-than-expected wireline revenues. While mobile service revenues were in line, the EBITDA margin trailed our forecast slightly due to higher-than-anticipated network expenses.

Good broadband revenue growth (4Q14: +7% YoY) and a sharp reduction in selling expenses (4Q14: -27%) were two key positive highlights in the results.

On the other hand, the trend in network costs, which rose by 33% YoY in 4Q14 after adjusting for CNY1.3bn in asset write-offs, surprised us negatively. The company attributed this to both the expansion of its network footprint and increases in property rentals. Given this miss, and the company's aggressive 4G plans – targeting the number of 4G base stations to rise from 180,000 in 2014 to 460,000 by end-2015 – network expenses would likely remain a focus area for investors in the quarters ahead.

Meanwhile, mobile operational trends bear resemblance to those at rival China Unicom (762 HK, HKD11.84, Outperform [2]). China Telecom's 4Q14 ARPU fell 10.2% YoY, though by lesser extent than at China Unicom (-14.6% YoY). In a similar vein, China Telecom also said that the ARPU of initial 4G users (around CNY90) is much higher than for its 2G/3G users (2014 3G ARPU: CNY67.5).

For 2015, management is guiding for a 12% YoY fall in selling expenses, as the company seeks to curtail channel commissions while maintaining subsidies at a level similar that in 2014. As a result, we are cutting our selling expense forecasts by 7.4-8.3% for 2015-16E.

In addition, we are raising our broadband ARPU forecasts by 3.6%, and network expense forecasts by 9.7-12% for 2015-16E. The aggregate effect of these changes is a minor (0.1-3%) upward revision to our 2015-16 EPS forecasts.

■ What we recommend

Driven by our EPS forecast changes, lower-than-forecasted 2014 net debt and after incorporating a lower discount rate (8.8% versus 9.5%

previously, driven by a 1pp decrease in 10-year bond yields over the past year), we raise our DCF-based 12-month target price to HKD5.50 (previously HKD5.00). We reiterate our Outperform (2) rating.

■ How we differ

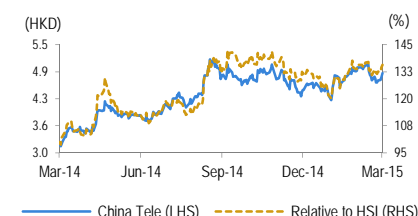
Unlike some in the market, we expect all the listed stocks in the China Telecom Sector, including China Telecom, to re-rate in the coming months, driven by low sector valuations and industry moves toward a tower-sharing model.

Forecast revisions (%)

Year to 31 Dec	15E	16E	17E
Revenue change	0.9	0.8	n.a.
Net profit change	3.0	0.1	n.a.
Core EPS (FD) change	3.0	0.1	n.a.

Source: Daiwa forecasts

Share price performance



12-month range	3.15-5.17
Market cap (USDbn)	50.46
3m avg daily turnover (USDm)	35.99
Shares outstanding (m)	80,932
Major shareholder	China Telecom Group (70.9%)

Financial summary (CNY)

Year to 31 Dec	15E	16E	17E
Revenue (m)	333,977	360,287	384,529
Operating profit (m)	31,633	36,899	41,334
Net profit (m)	19,848	23,700	27,258
Core EPS (fully-diluted)	0.245	0.293	0.337
EPS change (%)	12.3	19.4	15.0
Daiwa vs Cons. EPS (%)	(3.1)	1.7	(11.4)
PER (x)	15.9	13.3	11.6
Dividend yield (%)	2.2	2.6	3.0
DPS	0.085	0.102	0.117
PBR (x)	1.0	1.0	0.9
EV/EBITDA (x)	4.2	3.6	3.3
ROE (%)	6.7	7.6	8.3

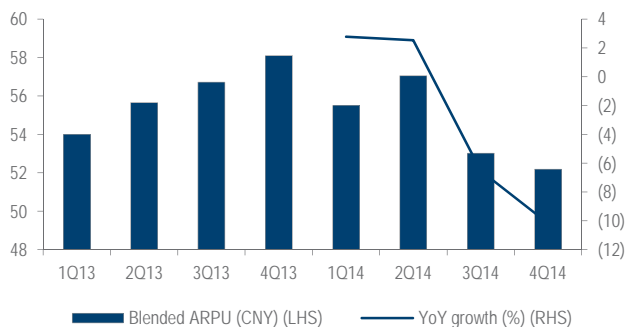
Source: FactSet, Daiwa forecasts

■ **China Telecom: 4Q14 results summary**

CNY billion	4Q13	1Q14	2Q14	3Q14	4Q14	% YoY	4Q14E	Var (%)	Remarks
Service revenue (excluding mobile terminal)	74.1	74.1	75.2	70.9	72.8	(1.8)	70.3	3.6	
Revenue	83.4	83.2	82.8	77.6	80.8	(3.1)	76.9	5.1	
EBITDA	21.8	25.1	25.5	24.3	20.1	(8.2)	19.8	1.3	
Net profit	2.8	5.5	5.9	4.7	1.6	(43.8)	1.4	13.8	
Revenue breakdown									
Wireless service revenue	30.2	30.7	31.3	29.2	29.1	(3.7)	29.2	(0.6)	Inline with forecasts
Wireline revenue	43.9	43.4	43.9	41.7	43.7	(0.4)	41.0	6.5	
Broadband	17.5	18.2	18.2	18.2	18.8	7.1	17.1	10.0	Key positive surprise
Voice and other wireline	26.4	25.2	25.7	23.5	24.9		24.0		
Costs									
Network costs	16.2	14.1	15.2	16.6	22.7	40.5	20.0	13.5	Key negative surprise
Personnel costs	12.0	13.0	11.6	14.6	11.4	(4.4)	12.2	(6.1)	
Selling expenses	19.3	18.5	18.4	11.7	14.1	(26.7)	14.4	(2.0)	
Margin									
EBITDA margin (ex mobile terminal sales)	29.5%	33.8%	33.8%	34.2%	27.6%	-1.9 pp	28.2%	-0.6 pp	
Operating data									
Mobile ARPU	58.1	55.5	57.1	53.0	52.2	(10.2)	52.5	(0.6)	Similar trend to China Unicom
Broadband ARPU	61.4	60.0	59.3	59.1	60.5	(1.6)	54.9	10.0	
Mobile net additions (m)	4.4	-2.4	-3.0	1.3	4.0		3.9		
Proportion of 3G/4G customers	55.6%	56.8%	59.5%	62.0%	63.9%		64.0%		
Fixed-line net additions (m)	-2.1	-3.0	-3.6	-2.9	-2.8		-2.8		

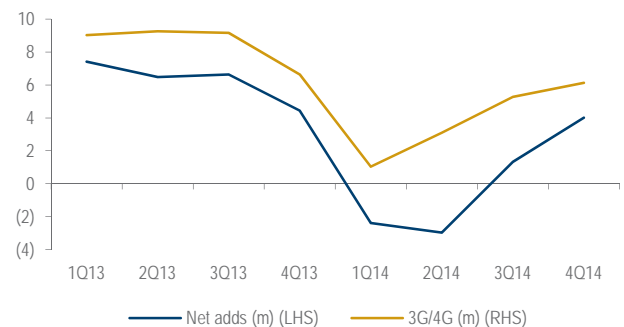
Source: Company, Daiwa forecasts

■ **China Telecom: mobile average revenue per user trend**



Source: Company

■ **China Telecom: mobile net additions trend**



Source: Company

■ **China Unicom: key changes to our forecasts (%)**

%	2015E	2016E
Service revenue	(1.4)	(1.4)
EBITDA	(0.6)	(1.8)
Service EBITDA margin	0.3 p.p	-0.1 p.p
Net profit	3.0	0.1

Source: Daiwa forecasts

■ **China Unicom: key changes to our assumptions (%)**

	2015E	2016E
Subscribers		
Wireless	0.1	0.1
Fixed-line	(1.4)	(1.4)
Fixed-broadband	(0.1)	(0.0)
Blended ARPU		
Wireless	(1.2)	(1.2)
Fixed-line	1.7	1.7
Fixed-broadband	3.6	3.6
Capex	(2.0)	(1.4)

Source: Daiwa forecasts

Financial summary

■ Key assumptions

Year to 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Subscribers (m)	90.5	126.5	160.6	185.6	185.6	206.0	231.5	254.5
2G Subscribers	78.2	90.2	91.6	82.5	67.0	57.4	44.6	33.2
3G Subscribers	12.3	36.3	69.1	103.1	118.6	148.6	186.9	221.3
Blended Average revenue per user per month (CNY)	54.3	52.4	53.9	54.8	54.0	54.3	55.1	55.9
Access lines (m)	175.1	169.6	163.0	155.8	143.6	137.6	133.6	129.6
Wireline Broadband Subscribers (m)	63.5	76.8	90.1	100.1	107.0	114.0	121.0	125.0
Access line ARPU (CNY)	28.6	24.1	21.7	20.2	18.7	18.1	17.6	17.1

■ Profit and loss (CNYm)

Year to 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Mobile	53,953	82,701	117,826	151,186	151,611	155,734	175,637	195,611
Fixed Line	165,911	162,340	165,247	170,398	172,783	178,244	184,649	188,918
Other Revenue	0	0	0	0	0	0	(0)	0
Total Revenue	219,864	245,041	283,073	321,584	324,394	333,977	360,287	384,529
Other income	0	0	0	0	0	0	0	0
COGS	0	0	0	0	0	0	0	0
SG&A	(144,053)	(169,688)	(212,232)	(225,033)	(229,541)	(233,275)	(248,981)	(264,761)
Other op. expenses	(51,656)	(51,224)	(49,655)	(69,083)	(66,345)	(69,070)	(74,407)	(78,434)
Operating profit	24,155	24,129	21,186	27,468	28,508	31,633	36,899	41,334
Net-interest inc./(exp.)	(3,600)	(2,254)	(1,564)	(5,153)	(5,291)	(5,591)	(5,814)	(5,593)
Assoc/forex/extraord./others	492	139	171	773	40	40	40	40
Pre-tax profit	21,047	22,014	19,793	23,088	23,257	26,082	31,125	35,781
Tax	(5,031)	(5,416)	(4,753)	(5,422)	(5,498)	(6,155)	(7,345)	(8,444)
Min. int./pref. div./others	(118)	(96)	(115)	(121)	(79)	(79)	(79)	(79)
Net profit (reported)	15,898	16,502	14,925	17,545	17,680	19,848	23,700	27,258
Net profit (adjusted)	15,898	16,502	14,925	17,545	17,680	19,848	23,700	27,258
EPS (reported)(CNY)	0.196	0.204	0.184	0.217	0.218	0.245	0.293	0.337
EPS (adjusted)(CNY)	0.196	0.204	0.184	0.217	0.218	0.245	0.293	0.337
EPS (adjusted fully-diluted)(CNY)	0.196	0.204	0.184	0.217	0.218	0.245	0.293	0.337
DPS (CNY)	0.071	0.070	0.068	0.075	0.075	0.085	0.102	0.117
EBIT	24,155	24,129	21,186	27,468	28,508	31,633	36,899	41,334
EBITDA	75,811	75,353	70,841	96,551	94,853	100,703	111,305	119,768

■ Cash flow (CNYm)

Year to 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Profit before tax	21,047	22,014	19,793	23,088	23,257	26,082	31,125	35,781
Depreciation and amortisation	51,656	51,224	49,655	69,083	66,345	69,070	74,407	78,434
Tax paid	(3,448)	(4,064)	(4,011)	(4,539)	(5,498)	(6,155)	(7,345)	(8,444)
Change in working capital	5,485	5,336	6,009	450	10,829	4,458	5,288	4,873
Other operational CF items	4,363	1,184	834	5,484	6,818	5,551	5,774	5,553
Cash flow from operations	79,103	75,694	72,280	93,566	101,751	99,006	109,248	116,196
Capex	(41,597)	(48,495)	(50,028)	(70,921)	(76,889)	(107,800)	(80,796)	(86,434)
Net (acquisitions)/disposals	(41)	(6)	0	0	0	0	0	0
Other investing CF items	(4,096)	4,864	1,776	(37,027)	(4,819)	0	0	0
Cash flow from investing	(45,734)	(43,637)	(48,252)	(107,948)	(81,708)	(107,800)	(80,796)	(86,434)
Change in debt	(32,483)	(21,453)	(14,431)	10,930	(3,400)	10,000	0	0
Net share issues/(repurchases)	0	0	0	0	0	0	0	0
Dividends paid	(5,608)	(6,174)	(5,625)	(5,433)	(6,098)	(6,085)	(6,898)	(8,237)
Other financing CF items	(4,212)	(2,781)	(1,359)	(5,075)	(6,175)	(5,591)	(5,814)	(5,593)
Cash flow from financing	(42,303)	(30,408)	(21,415)	422	(15,673)	(1,676)	(12,713)	(13,830)
Forex effect/others	1,480	(265)	923	(395)	(912)	0	0	0
Change in cash	(7,454)	1,384	3,536	(14,355)	3,458	(10,470)	15,739	15,932
Free cash flow	37,506	27,199	22,252	22,645	24,862	(8,794)	28,452	29,762

Source: FactSet, Daiwa forecasts

Financial summary continued ...

■ Balance sheet (CNYm)

As at 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Cash & short-term investment	27,792	29,176	32,712	18,357	21,815	11,345	27,084	43,016
Inventory	3,170	4,840	5,928	6,523	4,225	4,342	4,684	4,999
Accounts receivable	17,328	18,471	18,768	20,022	21,562	22,043	23,779	25,379
Other current assets	6,955	7,089	7,802	7,881	11,941	11,941	11,941	11,941
Total current assets	55,245	59,576	65,210	52,783	59,543	49,670	67,488	85,335
Fixed assets	289,693	287,325	406,227	418,498	426,057	473,771	480,161	488,161
Goodwill & intangibles	39,888	37,633	39,132	37,962	38,901	29,917	29,917	29,917
Other non-current assets	22,529	34,581	34,503	33,996	36,773	36,773	36,773	36,773
Total assets	407,355	419,115	545,072	543,239	561,274	590,132	614,339	640,186
Short-term debt	31,027	20,953	16,735	47,760	44,058	54,058	54,058	54,058
Accounts payable	93,251	104,212	175,072	151,136	161,207	166,263	173,629	180,417
Other current liabilities	2,645	2,093	1,654	1,202	1,060	1,099	1,138	1,177
Total current liabilities	126,923	127,258	193,461	200,098	206,325	221,420	228,825	235,652
Long-term debt	42,549	31,150	83,073	62,617	62,918	62,918	62,918	62,918
Other non-current liabilities	5,919	3,829	2,508	1,860	1,923	1,923	1,923	1,923
Total liabilities	175,391	162,237	279,042	264,575	271,166	286,261	293,666	300,493
Share capital	80,932	80,932	80,932	80,932	80,932	80,932	80,932	80,932
Reserves/R.E./others	150,536	175,158	184,137	196,809	208,251	222,014	238,816	257,836
Shareholders' equity	231,468	256,090	265,069	277,741	289,183	302,946	319,748	338,768
Minority interests	496	788	961	923	925	925	925	925
Total equity & liabilities	407,355	419,115	545,072	543,239	561,274	590,132	614,339	640,186
EV	361,628	339,063	383,405	408,291	401,434	421,904	406,164	390,232
Net debt/(cash)	45,784	22,927	67,096	92,020	85,161	105,631	89,892	73,960
BVPS (CNY)	2.860	3.164	3.275	3.432	3.573	3.743	3.951	4.186

■ Key ratios (%)

Year to 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Sales (YoY)	5.0	11.5	15.5	13.6	0.9	3.0	7.9	6.7
EBITDA (YoY)	0.2	(0.6)	(6.0)	36.3	(1.8)	6.2	10.5	7.6
Operating profit (YoY)	3.2	(0.1)	(12.2)	29.7	3.8	11.0	16.6	12.0
Net profit (YoY)	4.8	3.8	(9.6)	17.6	0.8	12.3	19.4	15.0
Core EPS (fully-diluted) (YoY)	4.8	3.8	(9.6)	17.6	0.8	12.3	19.4	15.0
Gross-profit margin	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
EBITDA margin	34.5	30.8	25.0	30.0	29.2	30.2	30.9	31.1
Operating-profit margin	11.0	9.8	7.5	8.5	8.8	9.5	10.2	10.7
Net profit margin	7.2	6.7	5.3	5.5	5.5	5.9	6.6	7.1
ROAE	7.0	6.8	5.7	6.5	6.2	6.7	7.6	8.3
ROAA	3.8	4.0	3.1	3.2	3.2	3.4	3.9	4.3
ROCE	7.6	7.9	6.3	7.3	7.3	7.7	8.6	9.2
ROIC	6.4	6.5	5.3	6.0	5.8	6.2	6.9	7.7
Net debt to equity	19.8	9.0	25.3	33.1	29.4	34.9	28.1	21.8
Effective tax rate	23.9	24.6	24.0	23.5	23.6	23.6	23.6	23.6
Accounts receivable (days)	28.9	26.7	24.0	22.0	23.4	23.8	23.2	23.3
Current ratio (x)	0.4	0.5	0.3	0.3	0.3	0.2	0.3	0.4
Net interest cover (x)	6.7	10.7	13.5	5.3	5.4	5.7	6.3	7.4
Net dividend payout	36.2	34.1	37.0	34.8	34.4	34.8	34.8	34.8
Free cash flow yield	11.9	8.6	7.1	7.2	7.9	n.a.	9.0	9.4

Source: FactSet, Daiwa forecasts

■ Company profile

China Telecom is an integrated information-services operator. The company provides cellular services, based on a CDMA technology platform, in addition to fixed-line and broadband services in China. As at the end of 2013, it had 156 wire-line subscribers and about 186m mobile subscribers. China Telecom's H shares and American Depositary Shares are listed on the Hong Kong Stock Exchange and New York Stock Exchange, respectively.

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