

JPM-pp1

Asia Pacific Equity Research

25 March 2015

Hutchison Whampoa Limited (13 HK)

Overweight

Price: HK\$103.60

24 Mar 2015

Price Target: HK\$124.00

PT End Date: 31 Dec 2015

A positive step for consolidation

We view the formal agreement for Hutch to purchase O2 a positive step for Hutch but not likely to move its share price in the near term as the terms of consideration were announced about two months ago. The factoring in of synergies from the acquisition is unlikely to happen until the transaction gets regulatory approval which may take at least a year. In the meantime, we believe the market will be focusing on the progress of the group restructuring exercise and the dispatch of the Hutch scheme document by the end of March. We remain positive on Hutch's post-restructuring driven by the synergy impact of the telecom acquisition and the improving return of its other core operations. OW maintained.

- **Hutch has entered into an agreement with Telefonica to purchase O2 in the UK.** The terms were the same as what were announced on 23 January. The immediate cash price is set at GBP9.25bn which would be paid at closing. A threshold agreement has been agreed for additional deferred upside interest sharing payments of up to a further GBP1bn after the cumulative cashflow of the combined businesses of Hutchison 3G UK Limited and O2 UK. They are only paid once the unlevered cumulative free cash flow of the combined entity reaches GBP1.85bn. Once the cumulative free cashflow exceeds GBP1.85bn, then payments are paid to Telefonica equivalent to 50% of the excess unlevered free cash flow until they get a further GBP1bn.
- **The deal values O2 UK at 6.6x 14 EV/EBITDA.** With a reported EBITDA of GBP1.4bn in 2014, the GBP9.25bn upfront purchase price value of O2 is 6.6x EV/EBITDA. We are not including the GBP1bn of deferred payment in the valuation given that the projected EBITDA is expected to be at a higher level when this benchmark can be reached. The transaction valuation is slightly lower than the European peers at 6.9x EV/EBITDA which we view is fair.
- In addition, according to a Bloomberg report, Hutch is in negotiation with a third party **financial investor that will be taking up 30% of the stake in O2.** If true, we believe this will help to alleviate the financial burden to Hutch. Given most of the details of this deal were announced in January, we believe it is unlikely to be a significant driver to the share price in the near term as completion of the transaction is expected to take at least one year. While Hutch's current gearing is at 23%, we estimate a 100% purchase of O2 will bring its net debt to equity/net debt to capital to 46%/31.4%. However, if 30% is taken up by a financial investor, we estimate **Hutch's net debt to equity/net debt to capital will be at 39%/28% which is much more manageable.**
- **Positive for Hutchison upon consolidation in the UK mobile market:** Hutchison has been showing interest in driving consolidation in the UK mobile market. The acquisition will reduce the number of players from 4 to 3 as BT unveils its potential purchase of EE as well. After the acquisition, Hutchison will become the largest player in the UK mobile market with an estimated 33 mn customers and an estimated market share of some 36%. The consolidation in Austria has been a successful example of Hutch's European telecom operation. **The company has previously expected that the NPV of the synergies will amount to about GBP3-4bn, accounting for at least 30% of the purchase costs.**
- **The transaction is still subject to regulatory approval:** The acquisition is subject to regulatory approval from the European Commission. We have seen successful approvals in Austria, Ireland and Germany for consolidation. However, there is likely to be remedy attached to the approval such as providing spectrum availability to MVNO.

Telefonica (TEF.MC) is covered by J.P. Morgan EMEA analyst Akhil Dattani.

Investment Thesis

We see further re-rating potential for Hutch driven by: 1) continued improvement in operating returns; 2) the growing importance of diversification in times of economic uncertainty; and 3) a pipeline of confirmed and potential corporate actions such as further M&A in the European 3G operation.

Valuation

Our Dec-15 PT of HK\$124 is based on the anticipated receipt of: 1) 0.684 CKH Holdings share (CKH valued at a target discount of 15% to its Dec-15 NAV of HK\$147.6); and 2) 0.684 CK Property share (CK Property valued at a target discount of 25% to its Dec-15 NAV of HK\$74.8).

Estimated Dec-15 NAV breakdown

Properties	Interest	Methodology	HK\$ mn	Attr. HK\$ mn	HK\$/shr	% of NAV
			151,354	151,354	35.5	20.5%
Investment properties						
Office		5.25% Yield	55,227	55,227	13.0	7.5%
Retail		5.25% Yield	15,525	15,525	3.6	2.1%
Others		5.5% to 8% Yield	29,708	29,708	7.0	4.0%
Sub-total			100,459	100,459	23.6	13.6%
China property		DCF	34,503	34,503	8.1	4.7%
Hotels		EBITDA Yield 6.5%	16,392	16,392	3.8	2.2%
Container ports	Various		166,831	125,748	29.5	17.1%
HPH Trust	27.6%	JPM valuation. PT=USD0.84	56,745	15,662	3.7	2.1%
Rest of the World		10.5x 15E EV/EBITDA	110,086	110,086	25.8	14.9%
Retail operations	75%	Last transaction price	177,000	132,839	31.2	18.0%
Energy and infrastructure			342,413	191,295	44.9	25.9%
Husky Energy	35%	Mkt price	175,194	60,530	14.2	8.2%
Cheung Kong Infrastructure	78%	JPM valuation. PT=HKD 67.00	167,219	130,765	30.7	17.7%
Telecommunication			23,751	16,681	3.9	2.3%
Hutchison Telecom Australia	88%	Mkt price	5,439	4,779	1.1	0.6%
HTHKH	65%	JPM valuation. PT=HKD 3.80	18,312	11,903	2.8	1.6%
3G	Various		128,138	119,605	28.1	16.2%
Gross NAV				737,522	173.0	100.0%
Adjusted net debt				-100,032	-23.5	
NAV				637,490	149.5	

Source: J.P. Morgan estimates.

Risks to Rating and Price Target

The key downside risk to our price target and rating would be shareholders voting down the proposed transaction which would forbid any value enhancement.

On the fundamentals front, we believe one of the key risks is a sharp deterioration in capital markets. Under such circumstances, the potential for asset monetization would be unlikely. Furthermore, regulatory considerations could prevent consolidation of the European 3G operations. For example, the European Commission has extended its investigation into Hutch's merger with O2 Ireland by 20 working days. Any sudden increase in the company's capex is also likely to derail our expectation of an improvement in its free cashflow.

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Telefonica (TEF.MC/€13.65/Not Rated)

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Date	Rating	Share Price (HK\$)	Price Target (HK \$)
14-Aug-09	N	57.30	64.00
18-Aug-10	OW	62.55	82.00
10-Nov-10	OW	83.45	94.80
11-Jan-11	OW	89.00	98.00
09-Feb-11	OW	93.75	113.00
11-Jul-11	OW	83.95	111.00
15-Sep-11	OW	66.60	104.00
06-Oct-11	OW	57.15	84.00
29-Aug-12	OW	68.45	85.00
27-Mar-13	OW	80.70	90.00
01-Aug-13	OW	87.70	108.00
25-Nov-13	OW	96.75	119.00
03-Mar-14	OW	105.70	133.00
11-Jan-15	OW	87.40	124.00

<http://gfd-app.emea.jpmchase.net:6080/server/console/chart/?shareClassId=121&shareClassServerId=1&chartDesignation=1&actionType=CHA>

Date	Rating	Share Price (€)	Price Target (€)
02-Oct-06	OW	13.67	16.30
20-Nov-06	OW	15.89	16.80
24-Nov-06	OW	15.60	18.00
16-Jan-07	OW	16.93	19.10
05-Mar-07	OW	15.77	19.50
02-Aug-07	OW	17.51	19.90
02-Oct-07	OW	19.40	22.10
18-Oct-07	OW	22.40	25.00
10-Apr-08	OW	19.10	22.00
02-Jun-08	OW	18.01	24.60
27-Jun-08	OW	16.76	22.30
22-Jul-08	N	16.32	20.50
17-Sep-08	N	16.83	20.00
10-Nov-08	OW	15.06	19.00
02-Apr-09	OW	15.38	19.50
05-May-09	OW	14.82	19.00
06-Oct-09	OW	19.13	20.00
24-Nov-09	OW	19.38	22.00
12-Jan-10	OW	18.50	21.00
08-Jul-10	OW	15.52	21.50
18-May-11	OW	16.78	20.50
02-Aug-11	OW	15.28	19.50
14-Nov-11	N	14.18	19.00
02-Mar-12	N	12.90	17.00
28-May-12	N	9.44	15.00
16-Oct-12	N	10.52	15.50
08-Nov-12	N	10.00	14.50
04-Mar-13	OW	10.10	13.00
22-Jul-13	NR	10.06	--

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