

COMPANY NOTE

Target Change

China | Technology | Comm. Equipment

26 May 2015

Jefferies

ZTE Corp. (763 HK) China TMT Tour: Key Takeaways from Meeting with ZTE

Key Takeaway

During Jefferies 13th China TMT tour, we hosted a meeting with ZTE. Key takeaways: (1) Increasing 4G market share in China, expect opportunities in broadband beyond 2015. (2) Enterprise market in China to drive long term growth. (3) Industry YTD smartphone shipments down YoY, expect FY15 flattish at best. Maintained FY15 smartphone target of 60mn. Revise up PT by 18% to HK\$33. Buy.

Increasing 4G market share in China; broadband opportunities beyond 2015.

According to management, CM's 4G Phase III market share has grown from 34% to 38%, CU's market share has increased to 32-35% (vs. 23-25% in 3G) and CT's market share is maintained at over 40%. In relation to Premier Li's comment on China's broadband infrastructure, ZTE expects increasing opportunities in FTTx/broadband access in China in the next few years. ZTE's positioning in the global market has become stronger as it proves its capability in the 4G market in China and competition has reduced further with the potential merger of Nokia and ALU.

Enterprise market drives long term growth.

In FY14, revenue from non-carrier was RMB3.5bn, accounting for ~4% of revenue. Management noted increasing demand in cloud computing equipment, more enterprise building data centers and increasing market share in servers and high end routers. As Internet+, smart cities and so on become the trend, the enterprise market will become a major revenue driver in the long term, in our view.

Weak smartphone demand in China; maintained 60mn smartphone target.

Management noted a decline in industry smartphone handset units sold YTD Jan-April 2015 vs. the same period in 2014. Expect slow growth in industry unit sales, or even a decline in FY15. In our view, this is mainly due to saturation of the smartphone market and late FDD-LTE licensing to CU/CT which needs 5-6 months to ramp up 4G network. Shipments should recover slightly in 2H15 as CU/CT become more aggressive in pushing 4G. ZTE maintained FY15 smartphone target of 60mn, of which 50-60% will be 4G.

Valuation/Risks

Reiterate Buy and raise PT by 18% to HK\$33, implying 25.5x/21.2x FY15E/FY16E PE, respectively, at high end of historical range of 9x-26x PE and 24% discount to A share. ZTE is currently trading at 21.7x FY15E PE, 18.5% premium to global peers and 35% discount to A share. ZTE will directly benefit from Chinese telcos' LTE capex peak in FY15, and capacity expansion in 2016. Risks include mgmt. execution as ZTE increases global expansion & builds its handset brand.

RMB	Prev.	2014A	Prev.	2015E	Prev.	2016E	Prev.	2017E
Rev. (MM)	--	81,471.3	--	91,184.0	--	98,711.0	--	104,971.0
Operating Profit	--	1,181.9	--	2,239.0	--	3,197.0	--	4,196.0
Net Profit	--	2,633.6	--	3,539.0	--	4,299.0	--	5,172.0
Dividend	--	0.20	--	0.21	--	0.25	--	0.30
Div. Yield		0.89%		0.93%		1.11%		1.33%
EPS Growth	--	93.9%	--	33.2%	--	20.4%	--	19.2%
EPS								
FY Dec	--	0.77	--	1.02	--	1.23	--	1.46
FY P/E		29.2x		22.0x		18.3x		15.4x

BUY

Price target HK\$33.00
(from HK\$28.00)
Price HK\$28.10

Bloomberg: 763 HK
Reuters: 000063 CH

Financial Summary

Book Value (MM):	HK\$31,608.0
Book Value/Share:	HK\$9.19
Net Debt (MM):	HK\$9,557.0
Return on Avg. Equity:	11.1%
Cash & ST Invest. (MM):	HK\$23,016.0

Market Data

52 Week Range:	HK\$28.55 - HK\$14.18
Total Entprs. Value (MM):	HK\$106,221.0
Market Cap. (MM):	HK\$96,664.0
Institutional Ownership:	76.3%
Shares Out. (MM):	3,440.0
Float (MM):	629.6
Avg. Daily Vol.:	7,252,009

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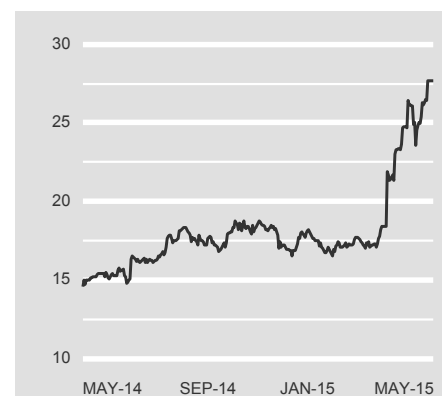
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Price Performance



Jefferies China TMT Tour Takeaways

We hosted a meeting with ZTE during our Summer TMT Tour. Key takeaways are as follows:

Increasing 4G market share in China; broadband opportunities beyond 2015.

ZTE's market share in the 4G market has further increased in the recent biddings. According to management, CM's 4G Phase III market share has increased from 34% to 38%, CU's market share has increased to 32-35% (vs. market share of 23-25% in 3G) and CT's market share was maintained at over 40%.

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Shipments should recover slightly in 2H15 as CU/CT become more aggressive in pushing 4G. ZTE maintained FY15 smartphone target of 60mn, of which 50-60% will be 4G.

Valuation

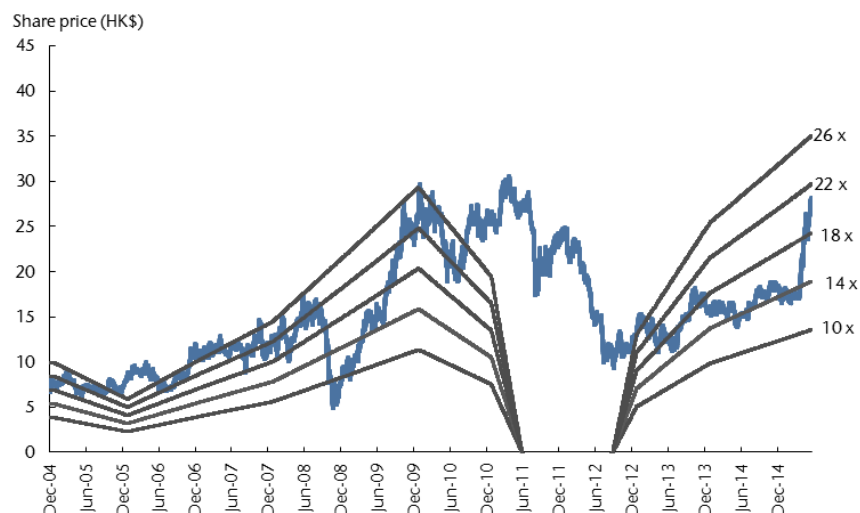
Reiterate Buy and revise up PT by 18% to HK\$33, implying 25.5x/21.2x FY15E/FY16E PE, respectively, at the high end of the historical range of 9x-26x PE and a 24% discount to the A share. ZTE is currently trading at 21.7x FY15E PE, 18.5% premium to global peers and 35% discount to the A share. ZTE will directly benefit from Chinese telcos' LTE Capex peak in FY15, and capacity expansion in 2016. Risks include mgmt. execution as ZTE increases global expansion and builds its handset brand.

Chart 1: Valuation Comparison

Company Name	Ticker	FX	Market Cap (USD mn)	Last Close	PE			EV/Sales			ROE			EV/EBITDA			Jefferies Ratings
					FY15	FY16	FY17	FY15	FY16	FY17	FY15	FY16	FY17	FY15	FY16	FY17	
ZTE Corporation	763 HK	HKD	17,924	28.10	21.7	18.0	15.1	1.0	0.9	0.8	13.5%	14.6%	15.4%	26.6	20.6	16.6	Buy
Motorola Solutions	MSI US	USD	12,585	59.66	18.0	15.4	15.0	2.2	2.1	2.1	41.5%	(105.9%)	n.a.	10.1	11.1	12.0	NC
Nokia (A)	NOK1V FH	EUR	26,302	6.56	21.9	19.1	16.8	1.3	1.3	1.2	14.8%	12.8%	12.8%	9.9	8.1	6.7	Hold
ERICSSON L.M.	ERICB SS	SEK	36,624	93.95	18.3	14.5	12.8	1.1	1.1	1.0	10.5%	12.8%	13.8%	8.7	7.2	6.2	Hold
Alcatel-Lucent	ALU US	USD	10,845	3.84	n.a.	12.9	9.5	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	7.4	6.5	n.a.	Hold
Cisco Systems	CSCO US	USD	148,813	29.26	13.5	12.9	12.2	2.4	2.3	2.2	18.1%	17.4%	18.7%	7.3	7.0	6.8	Hold
Juniper Networks	JNPR US	USD	10,897	27.60	16.4	14.5	13.1	2.1	2.0	1.9	12.3%	15.5%	15.0%	9.0	8.4	7.0	Hold
Average					18.3	15.3	13.5	1.7	1.6	1.5	18.5%	(5.5%)	15.2%	11.3	9.8	9.2	

Source: Bloomberg, Company data, Jefferies

Chart 2: Forward PE



Source: Bloomberg, Company data, Jefferies

Chart 3: Financial Summary

Profit and Loss statement						Cash flow statement					
Rmb mn	2013A	2014A	2015E	2016E	2017E	Rmb mn	2013A	2014A	2015E	2016E	2017E
Revenues	75,234	81,471	91,184	98,711	104,971	PBT ex. Exceptionals	1,828	3,538	4,910	5,965	7,176
COGS	(54,775)	(57,759)	(64,119)	(68,960)	(72,926)	Depn and amortization	1,745	1,826	1,056	1,071	1,095
Gross profit	20,459	23,712	27,065	29,750	32,046	Change in working cap.	(3,070)	(4,296)	(1,044)	(2,343)	(2,161)
Total SG&A	(21,920)	(23,121)	(25,826)	(27,353)	(28,650)	Others	(56)	34	(1,125)	(1,366)	(1,644)
EBITDA	581	2,244	3,294	4,268	5,291	CF from operations	447	1,102	3,797	3,326	4,466
Operating profit	(597)	1,182	2,239	3,197	4,196	Capex	(1,098)	(977)	(1,408)	(1,608)	(1,808)
Other income	4,905	4,561	4,698	4,982	5,282	Others	(73)	(1,045)	(1,519)	(1,671)	(1,838)
Finance cost	(1,650)	(1,562)	(1,527)	(1,615)	(1,703)	CF from investing	(1,171)	(2,022)	(2,927)	(3,278)	(3,645)
Profit/loss of JV/Asso	34	(53)	500	200	200	Free cash flow	(651)	125	2,389	1,719	2,658
Profit before tax	1,828	3,538	4,910	5,965	7,176	Equity raised/ (repaid)	0	0	0	0	0
Taxation	(394)	(811)	(1,125)	(1,366)	(1,644)	Dividends paid	0	0	(688)	(708)	(860)
Minority	(76)	(94)	(246)	(299)	(360)	Change in bank loan	(1,082)	(1,310)	3,000	3,000	3,000
Net income	1,358	2,634	3,539	4,299	5,172	Others	36	(606)	0	0	0
Shares outstanding	3,438	3,438	3,438	3,438	3,438	CF from financing	(1,045)	(1,916)	2,312	2,292	2,140
Wtg avg share	3,439	3,440	3,471	3,502	3,533	Total net cash provided	(1,769)	(2,836)	3,183	2,340	2,961
EPS (Rmb)	0.39	0.77	1.02	1.23	1.46	Exchange effect	(772)	(52)	0	0	0
DPS (Rmb)	0.03	0.20	0.21	0.25	0.30	Beginning net cash / (debt)	22,660	20,118	17,230	20,413	22,753
						Ending net cash / (debt)	20,118	17,230	20,413	22,753	25,714
Balance sheet						Ratio Analysis (%)					
Rmb mn	2013A	2014A	2015E	2016E	2017E		2013A	2014A	2015E	2016E	2017E
Cash	20,903	18,116	21,299	23,639	26,599	Gross margin	27.2%	29.1%	29.7%	30.1%	30.5%
Total receivable	40,370	41,434	47,027	52,261	57,014	EBITDA margin	0.8%	2.8%	3.6%	4.3%	5.0%
Inventories	12,434	19,592	18,655	21,008	23,215	Operating margin	-0.8%	1.5%	2.5%	3.2%	4.0%
Other current asset	5,115	7,148	7,206	8,191	9,146	Net profit margin	1.8%	3.2%	3.9%	4.4%	4.9%
Current asset	78,822	86,290	94,187	105,099	115,974	Revenue growth	-10.6%	8.3%	11.9%	8.3%	6.3%
Fixed assets and CIP	8,762	8,747	9,149	9,722	10,463	Gross profit growth	10.2%	15.9%	14.1%	9.9%	7.7%
Long term receivable	2,678	1,968	2,600	2,815	2,994	Net profit growth	-147.8%	94.0%	34.4%	21.5%	20.3%
Other non-current asset	12,210	13,249	14,717	16,352	18,161	EPS growth	-147.7%	93.9%	33.2%	20.4%	19.2%
Non-current asset	23,651	23,964	26,467	28,889	31,618	BVPS	6.6	7.2	8.0	8.9	10.1
Total Assets	102,473	110,255	120,654	133,988	147,592	Interest coverage (x)	(0.4)	0.8	1.5	2.0	2.5
Short-term loan	15,343	15,598	15,598	15,598	15,598	Net debt to total capital	12%	14%	13%	12%	11%
Accounts payables	28,673	33,451	35,010	38,220	41,017	Net debt to equity	25%	29%	25%	24%	21%
Other current liabilities	19,348	20,916	23,659	26,892	30,027	Sales/assets	71%	77%	79%	78%	75%
Current liabilities	63,364	69,965	74,267	80,710	86,642	Assets/equity	434%	419%	411%	403%	389%
Long-term bank loan	11,505	10,040	13,040	16,040	19,040	ROA	-0.6%	1.1%	1.9%	2.5%	3.0%
Other non-current liabilities	3,978	3,957	3,957	3,957	3,957	ROE	6.2%	11.1%	13.5%	14.6%	15.4%
Long-term liabilities	15,483	13,997	16,997	19,997	22,997	ROCE	-1.2%	2.3%	4.1%	5.2%	6.1%
Total liabilities	78,847	83,962	91,264	100,707	109,639						
Net debt	5,945	7,522	7,339	7,999	8,039						
Minority interest	1,093	1,414	1,660	1,959	2,318						
Shareholder's equity	22,533	24,879	27,730	31,322	35,634						
Total liability and equity	102,473	110,255	120,654	133,988	147,592						

Source: Jefferies, company data

Company Description

ZTE is principally engaged in the design, development, production, distribution and installation of a broad range of advanced telecommunications equipment, including carriers' networks, handsets, and telecommunications software systems and services.

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Hold - Describes securities that we expect to provide a total return (price appreciation plus yield) of plus 15% or minus 10% within a 12-month period.

Underperform - Describes securities that we expect to provide a total return (price appreciation plus yield) of minus 10% or less within a 12-month period.

The expected total return (price appreciation plus yield) for Buy rated securities with an average security price consistently below \$10 is 20% or more within a 12-month period as these companies are typically more volatile than the overall stock market. For Hold rated securities with an average security price consistently below \$10, the expected total return (price appreciation plus yield) is plus or minus 20% within a 12-month period. For Underperform rated securities with an average security price consistently below \$10, the expected total return (price appreciation plus yield) is minus 20% or less within a 12-month period.

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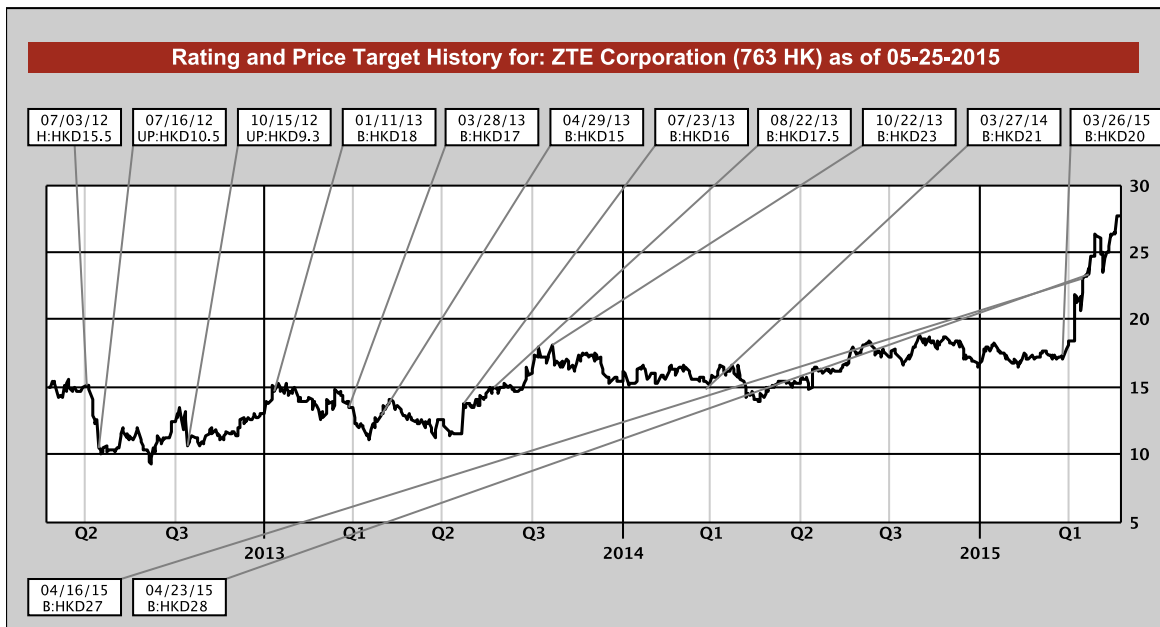
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- China Telecom Corp Ltd. (728 HK: HK\$5.49, HOLD)
- China Unicom (Hong Kong) Ltd. (762 HK: HK\$13.86, HOLD)
- Cisco Systems, Inc. (CSCO: \$29.26, HOLD)
- Ericsson (ERICB SS: SEK93.95, HOLD)
- Juniper, Inc. (JNPR: \$27.60, HOLD)
- Nokia (NOK1V FH: €6.53, HOLD)



Distribution of Ratings

Rating	Count	Percent	IB Serv./Past 12 Mos.	
			Count	Percent
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UNDERPERFORM	167	8.03%	12	7.19%

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