

Equity Research | China | Telecommunications

23 August 2016

A safe play

- China Telecom (CT)'s 1H16 headlines beat market expectations, reaffirming the positive industry trends of accelerating 4G subs growth and surging mobile and wireline data traffic in China.
- On the back improving earnings and cash flow, management hinted at more flexible dividend policy, a hike in DPS likely in our view.
- After nudging up FY16E/17E/18E earnings by 0.9%/1.1%/2.0, we raised our DCF based price target to HKD5.50 (from HKD5.20), implying 35.8% potential upside. Maintain Buy rating.

Transformation toward a data play. CT reported a solid set of 1H16 results, on strong data-laden growth including 4G, IDC (33.5% YoY revenue growth), cloud (40.9% YoY revenue growth) and big data (281.4% YoY revenue growth). With non-voice contributing 76.5% service revenue in 1H16 (versus 63.0% and 73.0 for its bigger and smaller domestic competitors respectively), CT is well poised to escalate its business transformation into its "3.0" stage, featuring intelligent network, ecological service and intellectual operation.

800MHz re-farming gives CT an edge in 4G. CT plans to start re-farming its 800MHz (2x 15MHz in total) (now occupied by its CDMA2000 network) for LTE, first in rural areas in 2H16 and nationwide deployment in 2017. The re-farming will not only substantially save CT's capex but also significantly improves its 4G coverage as well as the rising global trend of NB-IOT deployment. Without increasing capex guidance, CT plans to build 50k more 4G base stations to a total of 850k, versus previously guided 800k, by end-2016.

New convergence gaining traction. CT's new convergence services (4G, fiber broadband and HD IPTV) have been well received, helping boost ARPU and customer loyalties. Compared with its two domestic competitors, CT has a more balanced exposure in mobile and fixed-line, giving it an edge amid the growing industry trend of fixed and mobile integration in our view.

A safe play, rising favorable industry trends. After nudging up FY16E/17E/18E revenue by 1.0%/2.1%/2.8% (on higher 4G subs and IDC revenue) and earnings by 0.9%/1.1%/2.0%, we raised our DCF based price target to HKD5.50 (from HKD5.20), implying 35.8% potential upside. Given positive earnings trajectory over the coming 2-3 years, we see rising possibility for a sector-wide re-rating. Compared with its domestic peers, CT is a safe play, in contrast with regulatory risk with its bigger competitor and earnings risk with its smaller competitor in our view.

China Telecom (728 HK)

Buy

(unchanged)

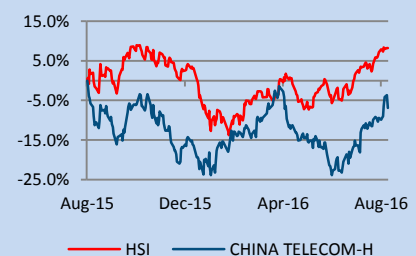
Price Target	HK\$5.50
(Revision)	(+5.8%)
(upside)	(35.8%)

EPS	2016E	2017E
revision	(+0.9%)	(+1.1%)

Close price	HKD4.05
Market cap.	USD42,278mn
Free float	22.2%
52-week range	HKD3.28 – HKD4.52
3-mth ave. T/O	HKD197.5mn

Price as of 23 Aug 2016

Stock rel HSI performance (%)



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Figure 1: CT 1H16 results summary

(RMB mn)	1H15	2H15	1H16	YoY
Fixed-line voice	15,268	14,575	13,580	-11.1%
Fixed-line data	8,480	8,733	8,843	4.3%
Fixed-line VAS	20,923	21,112	23,471	12.2%
Broadband	38,222	37,630	39,835	4.2%
Mobile voice	24,889	24,094	22,839	-8.2%
Mobile data	37,410	38,014	44,622	19.3%
Service revenue	145,192	144,158	153,190	5.5%
Mobile terminals	17,931	18,525	21,606	20.5%
Total revenue	164,953	166,249	176,828	7.2%
D&A	(33,585)	(34,079)	(33,447)	-0.4%
Network, operation & support	(37,224)	(44,016)	(43,951)	18.1%
SG&A	(25,062)	(29,410)	(27,319)	9.0%
Personnel expenses	(28,079)	(24,462)	(28,909)	3.0%
Interconnection & other expenses	(23,849)	(24,994)	(26,094)	9.4%
Operating expenses	(147,799)	(156,961)	(159,720)	8.1%
Operating profit	17,154	9,288	17,108	-0.3%
EBITDA	50,739	43,367	50,555	-0.4%
EBITDA margin	34.1%	28.9%	32.0%	-6.0%
Finance costs, net	(2,160)	(2,113)	(1,728)	-20.0%
Investment income	6	2	9	50.0%
Profit from associates	(456)	(242)	80	-117.5%
EBT	14,544	12,149	15,469	6.4%
Taxation	(3,536)	(3,015)	(3,747)	6.0%
Net profit	11,008	9,134	11,722	6.5%
Minority	(28)	(60)	(49)	75.0%
Attrib profit	10,980	9,074	11,673	6.3%

Source: Company

Figure 2: CT quarterly results summary

RMB mn	1Q15	2Q15	3Q15	4Q15	1Q16	2Q16
Service revenue	72,704	74,318	74,045	72,199	76,359	81,503
Sales of handsets	8,749	9,182	7,319	12,686	10,067	8,899
Revenue	81,453	83,500	81,364	84,885	86,426	90,402
D&A	(16,740)	(16,845)	(17,240)	(16,839)	(16,447)	(17,000)
Network, operation & support	(18,082)	(19,142)	(18,617)	(25,399)	(21,053)	(22,898)
SG&A	(12,136)	(12,926)	(13,019)	(16,391)	(13,922)	(13,397)
Personnel expenses	(15,162)	(12,917)	(14,065)	(10,397)	(15,358)	(13,551)
Interconnection & other expenses	(11,548)	(12,301)	(9,889)	(15,105)	(12,282)	(13,812)
Total operating expenses	(73,668)	(74,131)	(72,830)	(84,131)	(79,062)	(80,658)
Operating profit	7,785	9,369	8,534	754	7,364	9,744
EBITDA	24,525	26,214	25,774	17,593	23,811	26,744
Margin	33.7%	35.3%	34.8%	24.4%	31.2%	32.8%
Finance costs	(1,134)	(1,026)	(1,018)	(1,095)	(551)	(1,177)
Profit before tax	6,651	7,893	7,516	4,633	6,813	8,656
Taxation	(1,596)	(1,940)	(1,734)	(1,281)	(1,672)	(2,075)
Minority	(9)	(19)	(18)	(42)	(22)	(27)
Net profit	5,046	5,934	5,764	3,310	5,119	6,554
Blended ARPU (YTD)	53.8	55.1	55.5	54.1	55.0	55.6
Mobile MOU (min)	158.4	168.5	169.9	170.7	168.6	181.5
Handset data traffic (TB '000)	94.0	118.2	154.2	188.3	228.4	269.6
Fixed-line local voice usage (pulse, bn)	27.5	28.9	27.9	26.6	23.5	24.4

Source: Company

Income statement (RMBm)

Year end: Dec	2014	2015	2016E	2017E	2018E
Revenue	324,394	331,202	353,688	370,963	386,816
SG&A	(62,719)	(54,472)	(55,871)	(58,924)	(61,335)
Personnel	(50,653)	(52,541)	(52,801)	(55,969)	(58,241)
Other operating expenses	(16,169)	(130,083)	(146,123)	(152,661)	(159,024)
Other operating income					
EBITDA	94,853	94,106	98,893	103,409	108,216
Depreciation & Amortization	(66,345)	(67,664)	(65,703)	(68,081)	(70,222)
Other income	6	8	6	7	7
EBIT	28,514	26,450	33,197	35,335	38,001
Net interest	(5,291)	(4,273)	(4,356)	(4,156)	(3,299)
Associates	34	(698)	798	1,708	2,080
Exceptional items	-	-	-	-	-
Pretax profit	23,257	21,479	29,639	32,887	36,782
Taxation	(5,498)	(6,551)	(7,352)	(8,224)	(9,250)
Minority interests	(79)	(88)	(70)	(56)	(45)
Net profit	17,680	14,840	22,217	24,607	27,487
Net profit (adjusted)	17,680	20,054	22,217	24,607	27,487
Basic EPS (RMB)	0.22	0.25	0.27	0.30	0.34
EPS (adjusted) (RMB)	0.22	0.25	0.27	0.30	0.34
DPS (RMB)	0.08	0.08	0.08	0.09	0.90

Cash flow statement (RMBm)

Year end: Dec	2014	2015	2016E	2017E	2018E
EBIT	28,514	26,450	33,197	35,335	38,001
Depreciation & amortisation	66,345	67,664	65,703	68,081	70,222
Net interest	5,291	4,273	4,356	4,156	3,299
Taxes paid	(6,407)	(4,099)	(7,197)	(8,055)	(9,066)
Changes in working capital	8,796	18,940	3,147	6,040	6,146
Others	(6,134)	(4,478)	(5,294)	(4,389)	(2,140)
Cash flow from operations	96,405	108,750	93,911	101,168	106,462
Capex	(80,273)	(101,898)	(97,485)	(85,461)	(80,438)
Acquisitions	-	-	-	-	-
Disposals	-	-	-	-	-
Others	(1,435)	(352)	9,234	9,678	9,933
Cash flow from investing	(81,708)	(102,250)	(88,251)	(75,783)	(70,505)
Dividends	(6,198)	(6,160)	(6,850)	(7,503)	(72,745)
Issue of shares	-	-	-	-	-
Change in debt	(4,075)	110,133	(1,119)	(1,098)	(62,784)
Others	(54)	(44)	(84)	(88)	(93)
Cash flow from financing	(10,327)	4,809	(8,053)	(8,689)	(135,621)
Change in cash	4,370	11,309	(2,393)	16,696	(99,663)
Free cash flow	9,082	(14,343)	(5,945)	9,724	18,528

Balance sheet (RMBm)

Year end: Dec	2014	2015	2016E	2017E	2018E
Cash	20,436	31,869	29,476	46,171	(53,492)
Short term investments	1,379	2,519	2,519	2,519	2,519
Accounts receivables	21,562	21,105	21,801	22,530	23,294
Inventory	4,225	6,281	6,607	6,951	7,312
Other current assets	11,941	16,334	17,145	17,997	18,892
Total current assets	59,543	78,108	77,548	96,169	(1,475)
PP&E	372,876	373,981	391,946	402,296	405,409
Intangible Assets	38,901	40,659	42,522	44,263	45,874
Associates and JVs	4,106	34,473	35,271	36,979	39,059
Other long term assets	85,848	102,340	104,962	100,481	95,952
Total long term assets	501,731	551,453	574,701	584,020	586,295
TOTAL ASSETS	561,274	629,561	652,249	680,188	584,820
Short term debt	44,058	51,720	50,689	111,383	110,390
Accounts payables	88,458	18,055	24,145	30,550	37,288
Other current liabilities	73,809	86,154	88,007	92,963	98,274
Total current liabilities	206,325	255,929	262,841	334,896	345,952
Long term debt	62,494	64,830	64,742	2,950	(58,841)
Deferred tax	1,125	2,061	2,080	2,099	2,118
Convertible bonds					
Other long term liabilities	1,222	1,990	2,483	3,067	3,720
Total long term liabilities	64,841	68,881	69,305	8,116	(53,003)
TOTAL LIABILITIES	271,166	324,810	332,146	343,012	292,949
Shareholders' funds	289,183	303,784	319,150	336,254	290,997
Minority Interests	925	967	953	922	874
TOTAL LIAB AND EQUITY	561,274	629,561	652,249	680,188	584,820
Net cash / (debt)	(86,116)	(84,681)	(85,956)	(68,162)	(105,041)

Key ratios

Year end: Dec	2014	2015	2016E	2017E	2018E
Operating ratios					
EBIT margin (%)	8.8	8.0	9.4	9.5	9.8
EBITDA margin (%)	29.2	28.4	28.0	27.9	28.0
Effective tax rate (%)	23.6	30.5	24.8	25.0	25.1
Revenue growth (%)	0.9	2.1	6.8	4.9	4.3
Net income growth (%)	0.8	13.4	10.8	10.8	11.7
EPS growth adj (%)	0.8	13.4	10.8	10.8	11.7
DPS growth (%)	16	-	10.5	9.5	869.6
Efficiency ratios					
ROE (%)	6.1	6.6	7.0	7.3	9.4
ROCE (%)	5.7	4.8	5.8	6.1	6.5
Asset turnover (x)	0.6	0.5	0.5	0.5	0.7
Op cash / EBIT (x)	3.4	4.1	2.8	2.9	2.8
Depreciation / CAPEX (x)	0.8	0.7	0.7	0.8	0.9
Accounts receivable days	23.4	23.5	22.1	21.8	21.6
Accounts payable days	134.8	159.0	173.5	173.7	175.5
Leverage ratios					
Net gearing (%)	29.8	27.9	26.9	20.3	36.1
Net debt / EBITDA (x)	0.9	0.9	0.9	0.7	1.0
Interest cover (x)	5.4	6.2	7.6	8.5	11.5
Current ratio (x)	0.3	0.3	0.3	0.3	(0.0)
Valuation					
PER (x)	15.5	13.7	12.3	11.1	10.0
EV/EBITDA (x)	3.8	3.8	3.6	3.3	3.5
PBR (x)	0.9	0.9	0.9	0.8	0.9
Dividend yield (x)	2.3	2.3	2.5	2.7	26.6

Source: Company, Bloomberg, CSCI Research estimates

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Company Rating Definition

The Benchmark: Hong Kong Hang Seng Index; Time Horizon: 12 months

Buy	12-month absolute total return: $\geq 10\%$
Hold	12-month absolute total return: $> -10\%$ but $< 10\%$
Sell	12-month absolute total return: $\leq -10\%$

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