

Equity Research | China | Telecommunications

24 August 2015

## Rising 3G/4G technology advantages

- China Unicom (CU) reported a solid set of 1H15 bottom lines (beating expectations), in spite of weak service revenue. Besides VAT impact, the 9.8m loss in mobile subs and 11.5% drop in ARPU added to 9.7% YoY decline in mobile service revenue in 1H15.
- With a surge in 3G/4G base stations (+48% more from end-2014 to 837k by mid-2015), CU has started to report much stronger 3G/4G subs since June 2015 (5m+ in each of June and July 2015).
- After trimming 2016E/17E earnings by 2.7/3.4%, we lowered our DCF based price target to HKD15.50, implying 43.3% potential upside.

**Solid bottom-line figures.** CU reported a solid set of bottom-line figures for 1H15, with 5.8% YoY growth in EBITDA and 4.5% YoY growth in net profit. Instead, its service revenue (-5.3% YoY) came behind our and market expectation, primarily dragged by 9.7% drop in mobile services revenue. During 1H15, CU lost a total of 9.8m mobile subs and saw 11.5% lower in ARPU. Encouragingly, 1H15 saw strong growth in broadband (+8.5% YoY), wireline data (+12.7% YoY) and ICT (+23.3% YoY).

**3G/4G business likely to pick up from 4Q15.** During 1H15, CU built 272k 3G/4G base stations to a total of 837k (48% more from end-2014). With favorable wireless spectrum for 3G (U900 refarming) and 4G (1800MHz for FDD LTE) and advantageous 3G and 4G technologies (WCDMA and FDD LTE), CU is very competitive mobile voice + data network coverage for mass market users in China in our view. As evident, CU reported 5m+ net adds in 3G/4G subs in each of June and July 2015.

**Restructuring a necessary measure to revolve industry imbalance.** As we highlighted in our recent sector report ([Rising imbalance makes a case for industry restructuring](#), 29 July 2015), we see an industry restructuring increasingly imperative given rising imbalance in both the mobile and fixed-line telecoms market in China. In addition, CU would be a beneficiary of a potential top management reshuffle among in our view.

**Attractive valuation.** Assuming lower 3G/4G ARPU, we trimmed our 2016E/17E service revenue by 0.8/1.5% and earnings by 2.7/3.4% and lowered our DCF based price target to HKD15.50 (from HKD16.50), implying 43.3% potential upside. CU trades at 2016E 14.5x PER, 3.4x EV/EBITDA and 2.9% yield, looking attractive compared with either its domestic peers or major telcos worldwide in our view. Maintain Outperform rating.

## China Unicom (762 HK)

Recommendation	Outperform
Target Price	HK\$15.50
Price	HK\$10.82
Upside	43.3%
Market cap.(US\$ bn):	33.42

Stock rel HSI performance (%)



### Analysts

LIU Taisheng, Steven, CFA, PhD

(CE No.: AMO971)

[stevenliu@csci.hk](mailto:stevenliu@csci.hk) +852 3465 5652

**Figure 1: China Unicom summary 1H15 results**

<b>FY Dec (RMB mn)</b>	<b>1H14</b>	<b>2H14</b>	<b>1H15</b>	<b>YoY</b>
- 2G	26,963	22,305	20,727	-23.1%
- 3G & 4G	54,380	51,447	52,737	-3.0%
Mobile services	81,343	73,752	73,464	-9.7%
Fixed-line services	12,070	10,910	9,774	-19.0%
Broadband services	24,890	25,311	26,996	8.5%
Data communications	6,191	5,640	6,975	12.7%
ICT and other fixed-lines	2,479	2,292	3,057	23.3%
<b>Total service revenue</b>	<b>126,973</b>	<b>117,905</b>	<b>120,267</b>	-5.3%
Sales of telecom products	22,596	17,207	24,418	8.1%
<b>Total operating revenue</b>	<b>149,569</b>	<b>135,112</b>	<b>144,685</b>	-3.3%
Network operation and support	(18,035)	(19,816)	(19,154)	6.2%
Interconnection charges	(7,565)	(7,034)	(6,558)	-13.3%
Depreciation and amortisation	(36,882)	(36,986)	(38,543)	4.5%
Personnel	(16,969)	(17,683)	(17,925)	5.6%
Cost of telecoms products sold	(25,682)	(17,715)	(25,080)	-2.3%
Other operating expenses	(33,629)	(27,782)	(25,504)	-24.2%
<b>Total operating expenses</b>	<b>(138,762)</b>	<b>(127,016)</b>	<b>(132,764)</b>	-4.3%
<b>Operating profit</b>	<b>10,807</b>	<b>8,096</b>	<b>11,921</b>	<b>10.3%</b>
<b>EBITDA</b>	<b>47,689</b>	<b>45,082</b>	<b>50,464</b>	5.8%
Service EBITDA margin	37.6%	38.2%	42.0%	11.7%
Interest income	135	148	160	18.5%
Finance costs	(2,709)	(1,908)	(3,230)	19.2%
Other income, net	604	758	541	-10.4%
Profit before taxation	8,837	7,094	8,932	1.1%
Taxation	(2,148)	(1,728)	(1,942)	-9.6%
<b>Attrib profit</b>	<b>6,689</b>	<b>5,366</b>	<b>6,990</b>	4.5%

Source: Company

**Income statement (RMBm)**

Year end: Dec	2013	2014	2015E	2016E	2017E
Revenue	295,038	284,681	288,044	296,913	308,496
SG&A	(125,380)	(104,808)	(101,208)	(100,815)	(101,900)
Personnel	(31,783)	(34,652)	(36,385)	(38,204)	(40,114)
Other operating expenses	(53,912)	(52,450)	(53,592)	(55,887)	(57,969)
Other operating income	-	-	-	-	-
<b>EBITDA</b>	<b>83,963</b>	<b>92,771</b>	<b>96,860</b>	<b>102,007</b>	<b>108,513</b>
Depreciation & Amortization	(68,196)	(73,868)	(77,195)	(80,173)	(83,189)
Other income	887	1,362	1,470	1,490	1,512
<b>EBIT</b>	<b>16,654</b>	<b>20,265</b>	<b>21,135</b>	<b>23,325</b>	<b>26,835</b>
Net interest	(2,940)	(4,334)	(4,622)	(4,655)	(4,755)
Exceptional items	-	-	-	-	-
<b>Pretax profit</b>	<b>13,714</b>	<b>15,931</b>	<b>16,513</b>	<b>18,670</b>	<b>22,080</b>
Taxation	(3,306)	(3,876)	(4,034)	(4,567)	(5,407)
Minority interests	-	-	-	-	-
<b>Net profit</b>	<b>10,408</b>	<b>12,055</b>	<b>12,479</b>	<b>14,103</b>	<b>16,673</b>
Net profit (adjusted)	10,408	12,055	12,479	14,103	16,673
Basic EPS (RMB)	0.44	0.51	0.52	0.59	0.70
EPS (adjusted) (RMB)	0.44	0.51	0.52	0.59	0.70
DPS (RMB)	0.16	0.20	0.20	0.25	0.30

**Balance sheet (RMBm)**

Year end: Dec	2013	2014	2015E	2016E	2017E
Cash	21,506	25,308	25,238	21,089	13,326
Short term investments	54	56	62	68	75
Accounts receivables	14,842	14,671	15,845	17,112	18,139
Inventory	5,536	4,378	4,728	5,106	5,515
Other current assets	10,272	12,161	13,374	14,708	16,176
<b>Total current assets</b>	<b>52,210</b>	<b>56,574</b>	<b>59,246</b>	<b>58,084</b>	<b>53,231</b>
PP&E	431,625	438,321	465,376	477,423	484,882
Intangible Assets	2,771	2,771	2,771	2,771	2,771
Associates and JVs	-	3,037	3,037	3,037	3,037
Other long term assets	42,565	44,369	45,451	46,605	47,836
<b>Total long term assets</b>	<b>476,961</b>	<b>488,498</b>	<b>516,635</b>	<b>529,836</b>	<b>538,527</b>
<b>TOTAL ASSETS</b>	<b>529,171</b>	<b>545,072</b>	<b>575,881</b>	<b>587,920</b>	<b>591,757</b>
Short term debt	129,470	112,694	137,291	142,188	137,153
Accounts payables	102,212	120,371	119,167	117,976	116,796
Other current liabilities	63,557	58,855	58,426	58,624	59,161
<b>Total current liabilities</b>	<b>295,239</b>	<b>291,920</b>	<b>314,884</b>	<b>318,788</b>	<b>313,110</b>
Long term debt	2,481	23,880	23,895	23,756	23,608
Deferred tax	26	17	17	17	17
Convertible bonds	11,002	-	-	-	-
Other long term liabilities	1,524	1,714	1,821	1,937	2,063
<b>Total long term liabilities</b>	<b>15,033</b>	<b>25,611</b>	<b>25,733</b>	<b>25,710</b>	<b>25,688</b>
<b>TOTAL LIABILITIES</b>	<b>310,272</b>	<b>317,531</b>	<b>340,618</b>	<b>344,498</b>	<b>338,798</b>
Shareholders' funds	218,899	227,541	235,263	243,421	252,960
Minority interests	-	-	-	-	-
<b>TOTAL LIAB AND EQUITY</b>	<b>529,171</b>	<b>545,072</b>	<b>575,881</b>	<b>587,920</b>	<b>591,757</b>
Net cash / (debt)	(10,445)	(11,266)	(13,948)	(14,485)	(14,743)

Source: Company

**Cash flow statement (RMBm)**

Year end: Dec	2013	2014	2015E	2016E	2017E
<b>EBIT</b>	<b>16,654</b>	<b>20,265</b>	<b>21,135</b>	<b>23,325</b>	<b>26,835</b>
Depreciation & amortisation	68,196	73,868	77,195	80,173	83,189
Net interest	(2,940)	(4,334)	(4,622)	(4,655)	(4,755)
Taxes paid	(3,219)	(4,620)	(4,034)	(4,567)	(5,407)
Changes in working capital	(2,263)	(1,329)	(4,723)	(4,327)	(3,901)
Others	2,054	4,244	(4,871)	(5,358)	(5,800)
<b>Cash flow from operations</b>	<b>78,482</b>	<b>88,094</b>	<b>80,079</b>	<b>84,591</b>	<b>90,161</b>
Capex	(72,758)	(69,586)	(100,000)	(87,545)	(85,600)
Acquisitions	(6,050)	(3,807)	-	-	-
Disposals	1,522	796	(6)	(6)	(7)
Others	176	(2,722)	-	-	-
<b>Cash flow from investing</b>	<b>(77,110)</b>	<b>(75,319)</b>	<b>(100,000)</b>	<b>(87,552)</b>	<b>(85,607)</b>
Dividends	(2,686)	(3,677)	(4,756)	(5,945)	(7,135)
Issue of shares	1,102	871	-	-	-
Change in debt	6,196	(2,490)	29,368	10,703	1,951
Others	(2,686)	(3,677)	(4,756)	(5,945)	(7,135)
<b>Cash flow from financing</b>	<b>1,926</b>	<b>(8,973)</b>	<b>19,856</b>	<b>(1,188)</b>	<b>(12,318)</b>
<b>Change in cash</b>	<b>3,298</b>	<b>3,802</b>	<b>(70)</b>	<b>(4,148)</b>	<b>(7,644)</b>
Free cash flow	7,899	19,309	(7,174)	9,895	17,505

**Key ratios**

Year end: Dec	2013	2014	2015E	2016E	2017E
<b>Operating ratios</b>					
EBIT margin (%)	5.6	7.1	7.3	7.9	8.7
EBITDA margin	28.5	32.6	33.6	34.4	35.2
Effective tax rate (%)	24.1	24.3	24.4	24.5	24.5
Revenue growth (%)	18.5	(3.5)	1.2	3.1	3.9
Net income growth (%)	46.7	15.8	3.5	13.0	18.2
EPS growth adj (%)	52.9	15.2	3.5	13.0	18.2
DPS growth (%)	34.0	25.2	(0.7)	25.0	20.0
<b>Efficiency ratios</b>					
ROE (%)	2.0	2.2	2.2	2.4	2.8
ROCE (%)	7.1	8.0	8.1	8.7	9.6
Asset turnover (x)	0.6	0.5	0.5	0.5	0.5
Op cash / EBIT (x)	4.7	4.3	3.8	3.6	3.4
Depreciation / CAPEX (x)	0.9	1.1	0.8	0.9	1.0
Accounts receivable days	17.7	18.9	19.3	20.3	20.9
Accounts payable days	182.2	211.7	228.7	222.0	214.2
<b>Leverage ratios</b>					
Net gearing (%)	50.5	48.9	57.8	59.5	58.3
Net debt / EBITDA (x)	13	12	14	14	14
Interest cover (x)	5.7	4.7	4.6	5.0	5.6
Current ratio (x)	0.2	0.2	0.2	0.2	0.2
<b>Valuation</b>					
PER (x)	19.5	16.9	16.3	14.5	12.2
EV/EBITDA (x)	3.9	3.4	3.5	3.4	3.2
PBR (x)	0.9	0.9	0.9	0.8	0.8
Dividend yield (x)	1.9	2.3	2.3	2.9	3.5

## Company Rating Definition

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

<b>Outperform</b>	Relative Performance >10%
<b>Neutral</b>	Relative Performance is -10% to 10%
<b>Underperform</b>	Relative Performance <10%

### Disclosure of Interests

As of the date of this report,

1. The research analysts primarily responsible for the preparation of all or part of this report hereby certify that:
  - (i) the views expressed in this research report accurately reflect the personal views of each such analyst about the subject securities and issuers; and
  - (ii) no part of the analyst's compensation was, is, or will be directly or indirectly, related to the specific recommendations or views expressed in this research report.
2. The research analysts primarily responsible for the preparation of all or part of this report, or his/her associate(s), do not have any interest (including any direct or indirect ownership of securities, arrangement for financial accommodation or serving as an officer) in any company mentioned in this report,
3. This report has been produced in its entirety by China Securities (International) Brokerage Company Limited ("China Securities (International)") (CE Number: BAU373, regulated by the Securities and Futures Commission in Hong Kong)
4. China Securities (International) and each of its group companies that carry on a business in Hong Kong in investment banking, proprietary trading or agency broking in relation to securities have no financial interest, in aggregate, equal to or more than 1% of the market capitalization in the stocks reviewed in this report.
5. China Securities (International) and each of its group companies that carry on a business in Hong Kong in investment banking, proprietary trading or agency broking in relation to securities have not received compensation from or mandates for investment banking services in the past 12 months from listed corporations whose stocks are being reviewed by China Securities (International) in this report.
6. China Securities (International) and each of its group companies that carry on a business in Hong Kong in investment banking, proprietary trading or agency broking in relation to securities do not have any individual employed by or associated with them serving as an officer of a listed corporation whose stocks are being reviewed by China Securities (International) in this report.
7. China Securities (International) and each of its group companies that carry on a business in Hong Kong in investment banking, proprietary trading or agency broking in relation to securities are not market makers in the stocks reviewed by China Securities (International) in this report.

### Disclaimer

This report is for information purposes only and should not be construed as an offer to sell or to solicitation of an offer to buy or sell any securities in any jurisdiction. The securities referred to in this research report may not be eligible for sale in some jurisdictions. This information contained in this report has been compiled by China Securities (International) from sources that it believes to be reliable and (subject to the above Disclosure of Interests) the opinions, analysis, forecasts, projections and expectations contained in this report are based on such information and are expressions of belief only and no representation, warranty or guarantee is made or given by China Securities (International) or any its accuracy or completeness. All opinions and estimates expressed in this report are (unless otherwise indicated) entirely those of China Securities (International) as of the date of this report only and are subject to change without notice. Such opinions and estimates may be different from or contrary to the opinions presented by the other business departments, units or affiliates of China Securities (International), as different assumptions and standards, different views and analytical methods may be adopted in the preparation of such other materials, and China Securities (International) is under no obligation to bring such other materials to the attention of any recipient of this report. Neither China Securities (International) nor its holding companies and affiliates accept any liability whatsoever for any direct or consequential loss arising from any use of material contained in this report or otherwise arising in connection therewith.

Any investment referred to herein may involve significant risk, may be illiquid and may not be suitable for all investors. The value of or income from any investment referred to herein may fluctuate and be affected by changes in exchange rates. Past performance is not indicative of future results. This report does not take into account the investment objectives, financial situation or particular needs of any particular person. Investors are expected to make their own investment decision without relying on this publication. Before entering into any transactions in any securities referred to in this research report investor should consider their own individual investment objectives and financial situation and seek professional financial, tax and legal advice, as necessary.

This report is strictly confidential to the recipient. It is being supplied to you solely for your information and may not be reproduced, redistributed or passed on, directly or indirectly, to any other person or published, in whole or in part, for any purpose. The distribution of this report in other jurisdictions may be restricted by law, and persons into whose possession this report comes should inform themselves about, and observe, any such restrictions. By accepting this report you agree to be bound by the foregoing instructions.

### China Securities (International) Research

18/F, Two Exchange Square, Central, Hong Kong

Tel: (852) 34655600 Fax: (852)21809495