

China Mobile: Strong cash flow with scale advantage

Core competitiveness of China Mobile: We believe China Mobile(941.HK) has scale advantage with its dominant mobile market share. China Mobile is the largest telecom operator in China. It has over 910mn mobile users (4G subscribers: 695mn), reaching almost 60% of China totaled 1,546mn mobile users (4G subscribers: 1,150mn). We think the scale advantage will allow CM to have a higher margin.

Number of subscribers is still growing: We think unlimited and high capacity data plans launched in 3Q18 will help with customer acquisition including 4G subscribers. We expect the above positive effect can more than offset the declining ARPU and CM revenue can achieve low-single-digit revenue growth.

Jump in mobile traffic: CM's mobile data traffic grew exponentially, driven by strong growth of data of usage (demand for sharing images, streaming music, high definition video or playing games, etc). Looking forward, considering that 5G will bring disruptive changes to the development of drones, connected cars, industrial Internet and robots, we can foresee even higher demand for mobile traffic in long run, alleviating the negative impact of 'lower speed, tariff reduction policy' addressed by Central government.

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CM Fixed Broadband is a future bright spot: After the integration with Tietong in recent years, China Mobile further enhanced its fixed network capacity, coverage and efficiency, its wireline broadband customers recorded a positive trend and exceeded 147 million in 3Q18, we expect the integration of mobile and fixed business can increase customer loyalty and reduce churn rate with the provision of bundled services. We see internet of things (IoT), internet data center (IDC) and cloud segments are the emerging fixed-line areas.

CM's 5G Capex lower than expected: CM will be allocated 100MHz in the 2.6GHz band for 5G, resulting in lower capex (enabling it to re-use existing 3G and 4G locations for its 5G network rollout). Also, we do not see a strong capex demand in the near term. We forecast 2018/19/20 capex of CM will grow by -16.7%/8.8%/22.6% YoY vs. 0.5%/12%/25% YoY in 2012/13/14, leading to a healthy near term outlook for free cash flow.

CM dividend yield with stable growth remain attractive: We forecast CM to deliver a dividend yield of around 4% in 2018, higher than its long run average. We predict its EPS will record a low single digit growth with strong free cash flow for the next 3 years, which can provide support to its DPS growth.

Initiate “Buy” with target price of HKD86: CM’s BEST EV/EBITDA is around 3.2X, lower than 10-year average of 4X. Our target price of HKD86, implies 12% upside based on our FCF model (assume growth rate in perpetuity=2%, market risk premium=10%, beta=0.77). We initiate our Buy rating as we think 5G capex risk is overdone and current stock valuation and dividend yield are attractive. We also like CM’s highly defensive telecom business especially when economy may slow down.

Figure. China Mobile and its peer valuation and earning forecast

	Stock Code	Price (\$LC)	TP	%upside	18ROE	19ROE	18PB	19PB	18EV/EBITDA	19EV/EBITDA	18 Div yld	19 Div yld
CHINA MOBILE	941 HK Equity	76.65	86.00	12.2%	11.42	10.79	1.33	1.26	3.35	3.28	4.03	4.10
CHINA UNICOM	762 HK Equity	8.88	NA	NA	2.71	4.22	0.74	0.72	2.88	2.71	1.51	2.31
CHINA TELECOM-H	728 HK Equity	4.13	NA	NA	6.09	6.36	0.88	0.85	3.42	3.29	2.81	3.00
VERIZON COMMUNIC	VZ US Equity	59.17	NA	NA	38.74	32.33	4.47	3.74	7.52	7.35	4.03	4.14
AT&T INC	T US Equity	29.95	NA	NA	13.32	11.41	1.21	1.18	6.97	6.48	6.70	6.82
SPRINT CORP	S US Equity	6.19	NA	NA	0.62	2.75	0.89	0.89	4.63	4.72	0.00	0.00
T-MOBILE US INC	TMUS US Equity	67.49	NA	NA	11.85	12.61	2.28	2.00	7.12	6.73	0.00	0.00
NTT DOCOMO INC	9437 JP Equity	2615.00	NA	NA	12.35	11.73	1.62	1.55	6.02	6.35	4.19	4.47
KDDI CORP	9433 JP Equity	2635.00	NA	NA	15.69	14.90	1.54	1.43	5.03	4.99	3.81	4.12
SOFTBANK GROUP C	9984 JP Equity	9111.00	NA	NA	11.11	16.90	1.64	1.32	9.01	9.16	0.49	0.49
DEUTSCHE TELEKOM	DTE GR Equity	15.32	NA	NA	13.21	15.25	2.20	2.19	6.11	5.79	4.56	4.92
VODAFONE GROUP	VOD LN Equity	164.82	NA	NA	4.36	5.14	0.78	0.79	5.69	5.54	8.00	8.16
TELEFONICA	TEF SM Equity	7.66	NA	NA	19.49	19.07	2.06	1.92	6.08	6.14	5.25	5.30
ORANGE	ORA FP Equity	14.89	NA	NA	8.90	9.40	1.27	1.23	5.71	5.58	4.73	5.00
Median					11.63	11.57	1.44	1.29	5.87	5.69	4.03	4.13
Average					12.13	12.35	1.64	1.50	5.68	5.58	3.58	3.77

Source: Bloomberg, CASH

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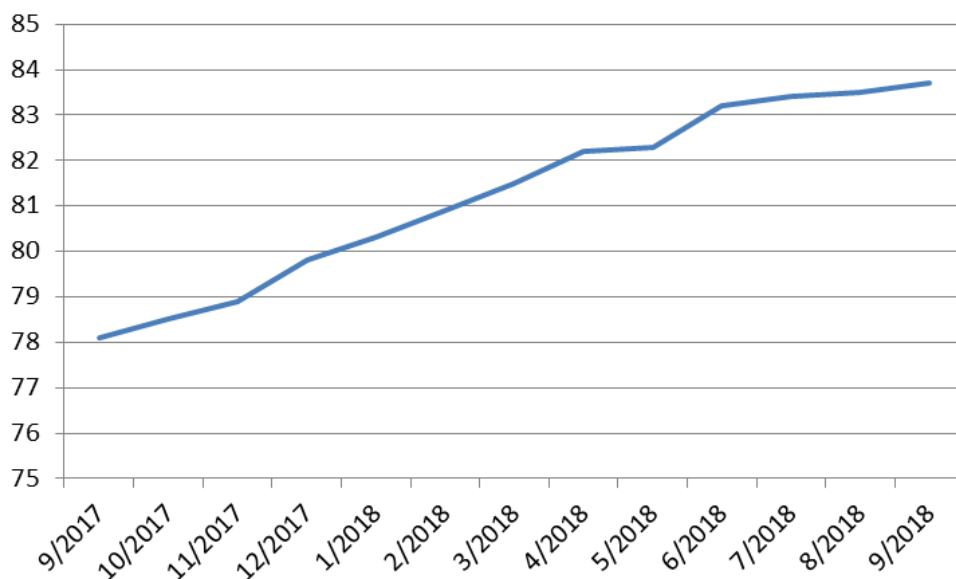
The Telecom Industry

This listing of China Tower (788.HK) in 8 Aug 2018 was regarded as an upward rerating catalyst for the China Telecoms sector. But the bullish expectation failed to materialize. Market attention is likely to turn to 5G transition and competition in unlimited data plans. The initial set of specifications for the standalone 5G network technology (Release 15) were frozen in Jun 2018 while the phase 2 (Release 16) will be scheduled for finalization towards end 2019.

We see that commercial launch of 5G in 2020 is likely. Operators can leverage 5G functionality (network slicing which helps divert 5G resources optimally to different scenarios like eMMB, mMTC and URLLC) and applications (like AR, VR, IoT for smart city, autonomous driving, drone) to provide superior and differentiated services, capturing a new revenue stream. We think the 5G capex cycle will start at 2020 which may involve the extensive use of small cells for the provision of dense and low-latency applications. **This may imply a healthy free cash flow to China Telecom sector for 2019 as 4G investments are gradually monetarized with 5G capex cycle not yet started.**

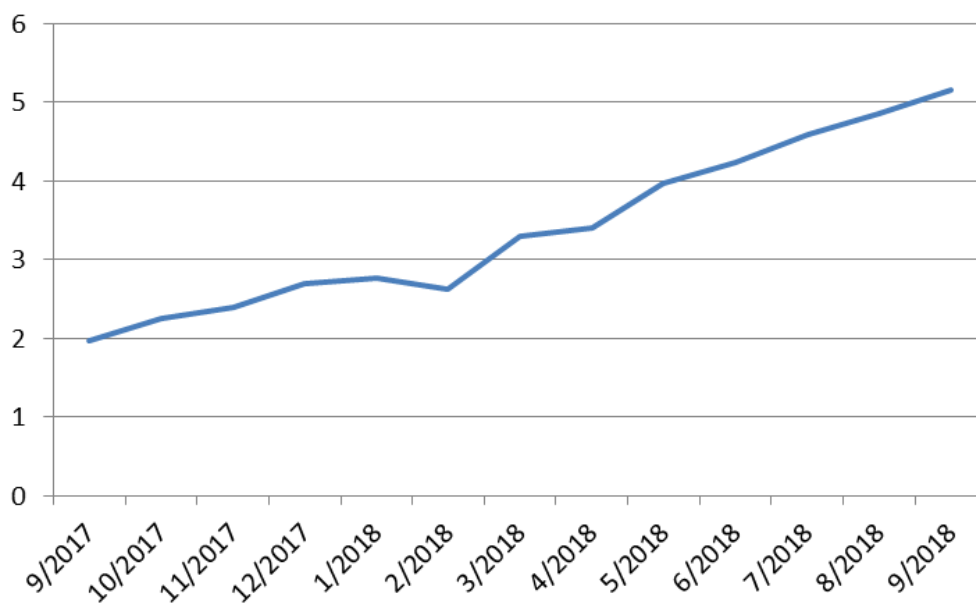
Thanks to (1) unlimited data packages with lower price points launched by the telecom operators, (2) rising popularity of dual-model handsets, China mobile users have recorded an accelerating growth recently. China Unicom(762.HK) issued the highest number of unlimited SIM cards through cooperation with internet firms. For now, the overall mobile users reach around 1.6 bn, with mobile broadband users accounting for ~84% of total mobile users (4G users represented ~74% of total mobile users) driven by reduced mobile data service tariff. At the same time, mobile internet access traffic per user per month has been increasing at a high single digit pace recently to more than 5GB. We expect **(1) further increase in penetration rate of mobile broadband users** coupled with **(2) rising data demand provides a growth stabilizer to China Telecom operators** amid declining average revenue per user (ARPU). We like China telecom operators due their defensiveness amid deteriorating macro uncertainties.

Figure. Mobile broadband users (3G/4G) as a percent of total mobile users



Source: MIIT

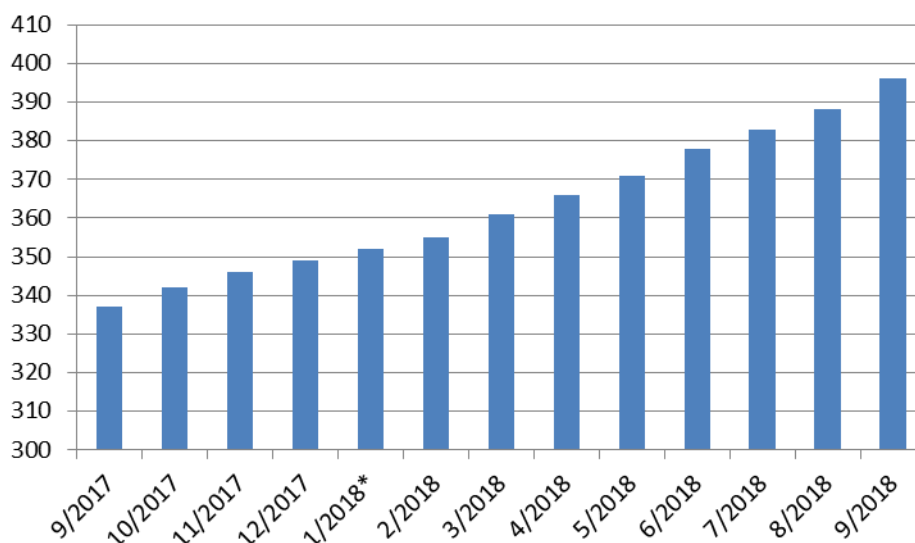
Figure. Mobile internet access traffic per user (GB/user)



Source: MIIT

On the other hand, **(3) the strong user growth in fixed line broadband** due to the launch of value-added services and quality video contents by telecom operators will continue to support data service revenue.

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Figure: China fixed broadband subscribers (in mn)

Source: MIIT

Core competitiveness of China Mobile

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Positive signs of China Mobile

1. Number of subscribers is still growing

Due to the large presence in rural and regional areas, CM's mobile ARPU will continue to be negatively impacted by the cancellation of data roaming on a YoY basis until the end of 2Q19 (previously elimination of voice roaming tariffs played out by 3Q18). **However, we think unlimited and high capacity data plans launched in 3Q18 will help with customer acquisition including 4G subscribers. We expect the above positive effect can more than offset the declining ARPU and CM revenue can achieve low-single-digit revenue growth.**

Figure: CM number of subscribers(mn)

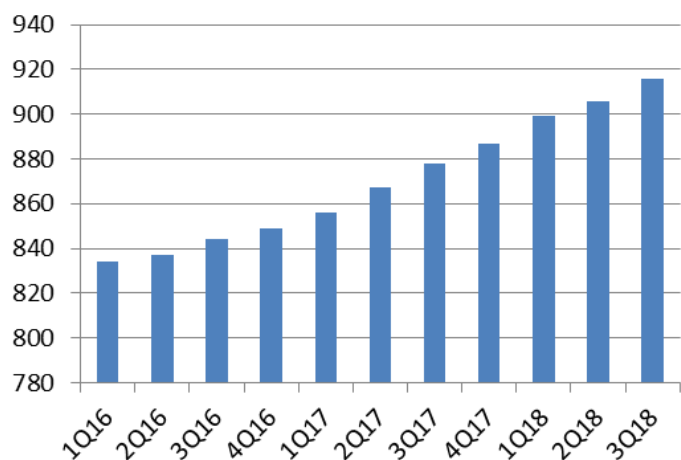
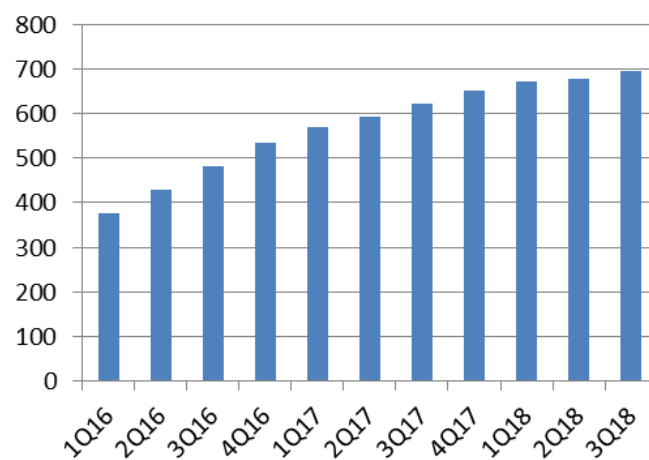
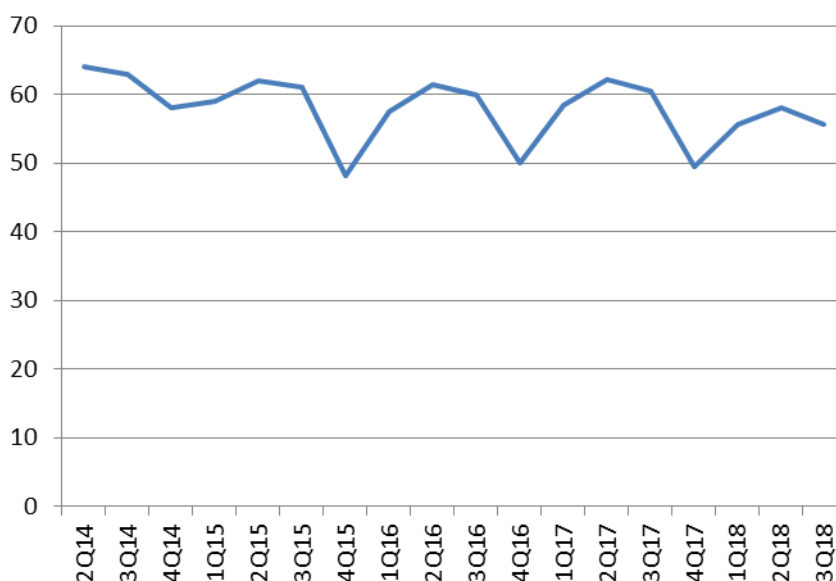


Figure: CM number of 4G subs (mn)



Source: China Mobile, CASH

Figure: CM declining mobile ARPU (in RMB)

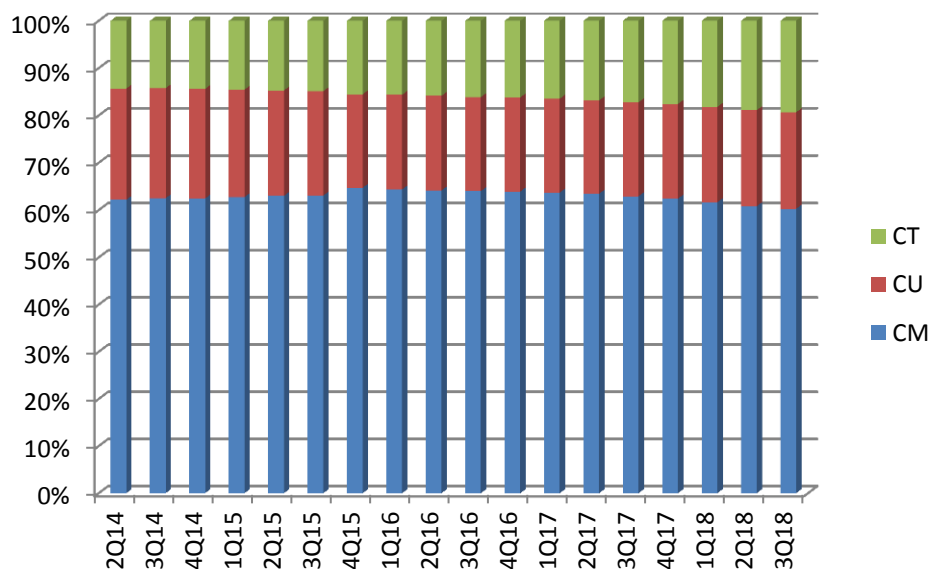


Source: China Mobile, CASH

CM has lost its mobile subscriber market share since 2016, mainly due to uncompetitive pricing, but we see subscriber market reaching the inflection point. (maybe an intention to alleviate the potential regulatory risk arising from being overly dominant). Our recent checks suggested that CM's pricing of mobile data plan has cut to almost aligned with its peers (CM's Beijing 'Freely Use it Nationwide' package (任我用全國不限量套餐) RMB78 vs. RMB238 before). CM has the cost advantage/ stronger cash position/ strong customer experience (lowest rate of network complaints) compared with peers, market share loss will not be sustainable.

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Figure: Major 3 telecom operators' market share of mobile subscribers

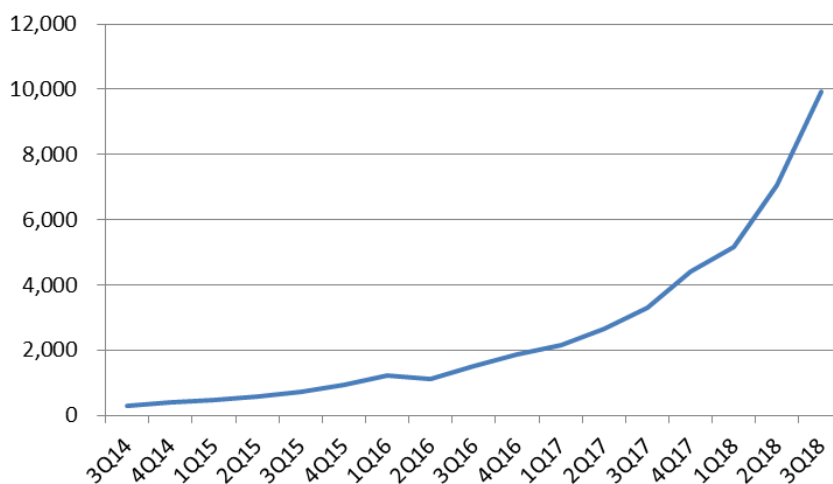


Source: CM, CU, CT, CASH

2. Jump in mobile traffic also helps

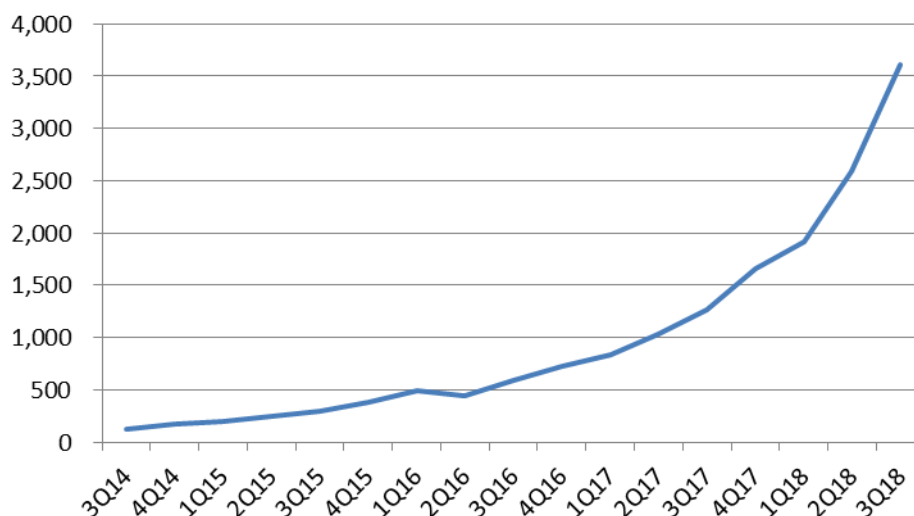
CM's mobile data traffic grew exponentially, driven by strong growth of data of usage (**demand for sharing images, streaming music, high definition video or playing games**, etc). Looking forward, considering that 5G will bring disruptive changes to the development of drones, connected cars, industrial Internet and robots, we can foresee even higher demand for mobile traffic in long run, alleviating the negative impact of 'lower speed, tariff reduction policy' addressed by Central government.

Figure: Mobile data traffic (MB in bn)



Source: China Mobile, CASH

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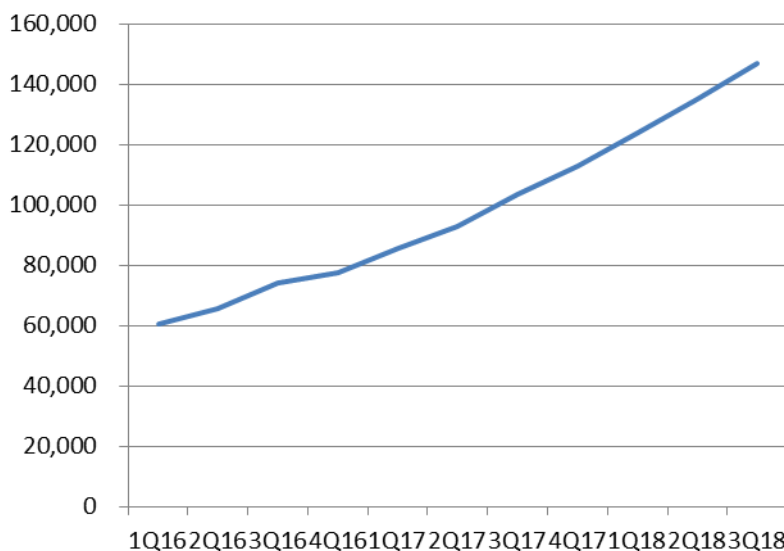
Figure: Data of usage (DOU) (MB/user/month)

Source: China Mobile, CASH

3. CM Fixed Broadband is a future bright spot

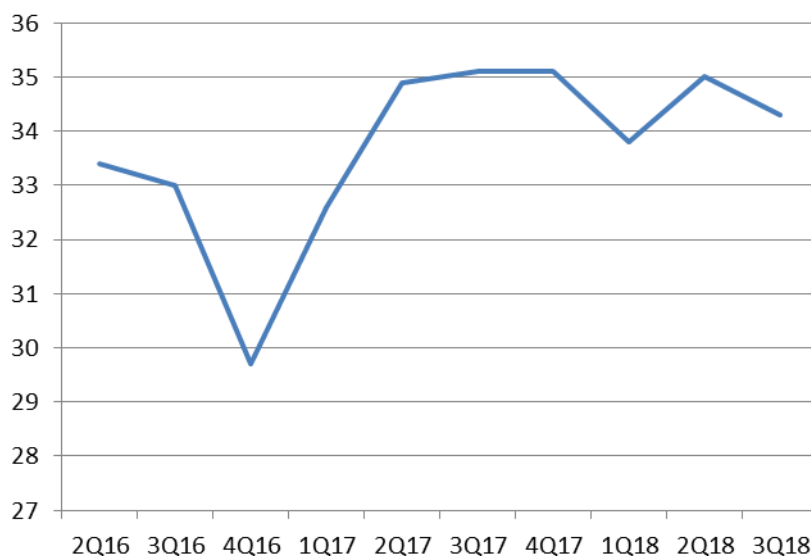
A few years ago, China Mobile acquired part of the asset business of China TieTong Group for more than RMB30 billion, and obtained a fixed broadband license and expanded this part of the business. After the integration with Tietong in recent years, China Mobile further enhanced its fixed network capacity, coverage and efficiency, its wireline broadband customers recorded a positive trend and exceeded 147 million in 3Q18, we expect the integration of mobile and fixed business can increase customer loyalty and reduce churn rate with the provision of bundled services, and the trend will go on in the near future with stable ARPU (RMB34-35, discount to its bigger peers), and finally overtaking China Telecom to become the market leader. We see internet of things (IoT), internet data center (IDC) and cloud segments are the emerging fixed-line areas.

Figure: Wireline broadband - number of subscribers ('000)



Source: China Mobile, CASH

Figure: Wireline broadband – ARPU (in RMB)



Source: China Mobile, CASH

4. CM’s 5G Capex lower than expected

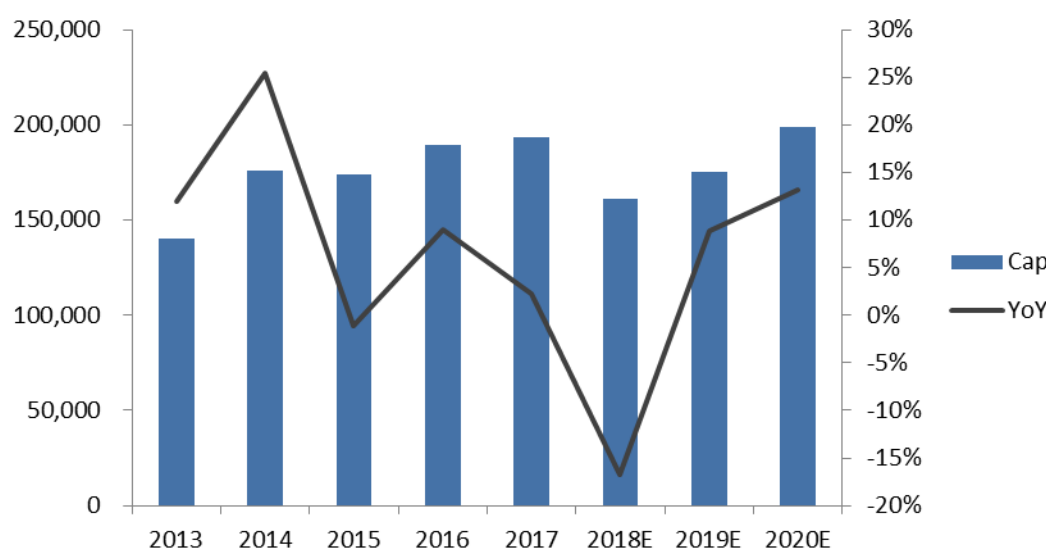
Previously, market expects CM will have much 5G burden by using the 4.8GHz spectrum band, while its two smaller peers will be allocated the 3.5GHz band, which is the global standard. But CM will be allocated 100MHz in the 2.6GHz band for 5G, resulting in lower capex (enabling it to re-use existing 3G and 4G locations for its 5G network rollout). We think that is positive to CM as (1) CM will have 3x more 5G spectrum than CT and CU; (2) the 2.6Ghz is adjacent to

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CM's 4G LTE spectrum, enabling it to leverage its current infrastructure to rollout 5G rapidly and inexpensively, which can ensure its 5G leadership.

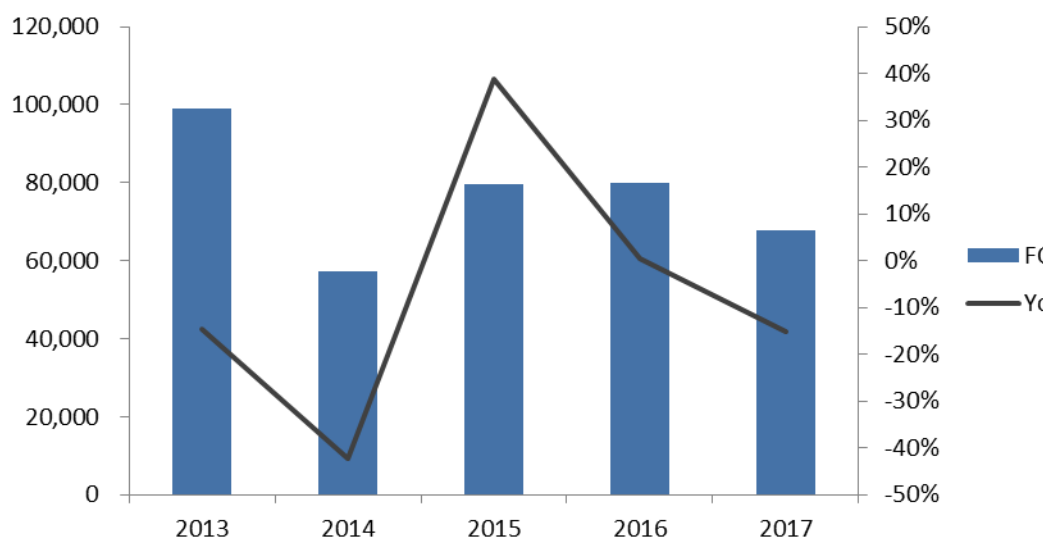
Also, ramp up in 5G capex is likely to be slower than that of 4G which pick up fast at initial stage, since China Telecom operators initially focus on 5G outdoor coverage, along roads or areas for IoT and edge computing activities, with indoor coverage rollouts coming after 2021. Also, the utilization rates of CM, CT and CU are 40%, 36% and 65% as of mid-2018, which means CM has a rate lower than the benchmark rate that require major network capacity upgrade. As CM is able to handle the sudden increase in data usage, we do not see a strong capex demand in the near term. We forecast 2018/19/20 capex of CM will grow by -16.7%/8.8%/22.6% YoY vs. 0.5%/12%/25% YoY in 2012/13/14, leading to a healthy near term outlook for free cash flow.

Figure: CM's 5G capex (in mn RMB)



Source: China Mobile, CASH

Figure: CM's FCF (in mn RMB)



Source: China Mobile, CASH

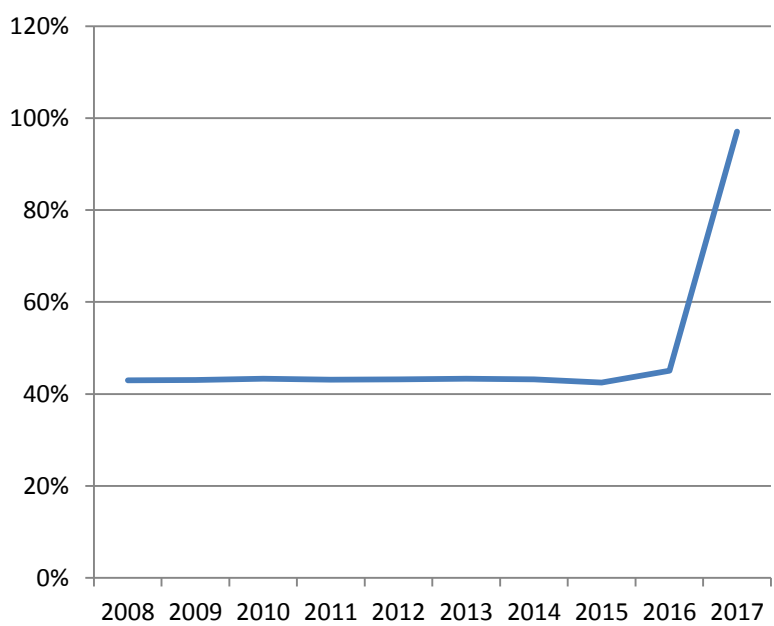
5. CM will be the biggest beneficiary in 5G

We do not believe many consumers are willing to pay a higher ARPU for 5G low latency and high speed as 4G is good enough for high-resolution video and gaming. Applications like surveillance, edge computing, AR/VR, autonomous driving, IoT are designed for corporate users who are less price sensitive but quality sensitive. In this sense, CM is likely to become the biggest beneficiary due to its quality service. Also, its widest coverage will continue to provide scale advantage and margin in 5G.

6. Improvement in payout ratio

China Mobile has the strongest financial position among the three major telecom operators in China. As of June 2018, China Mobile recorded net cash with RMB382bn cash & cash deposits with no debt, its cash ratio reached 88%, the highest among its global peers. Its cash reserves provide a good buffer for capex increase from 5G rollout. CM enhanced its payout ratio in the last 2 years after 9 years of flat payout given the gradual monetization after 4G roll-out completion and higher demand from the government in improving SOE payout.

Figure: CM's dividend payout



Source: China Mobile, CASH

Figure: CM's dividend yield for the past 10 years



Source: Bloomberg, CASH

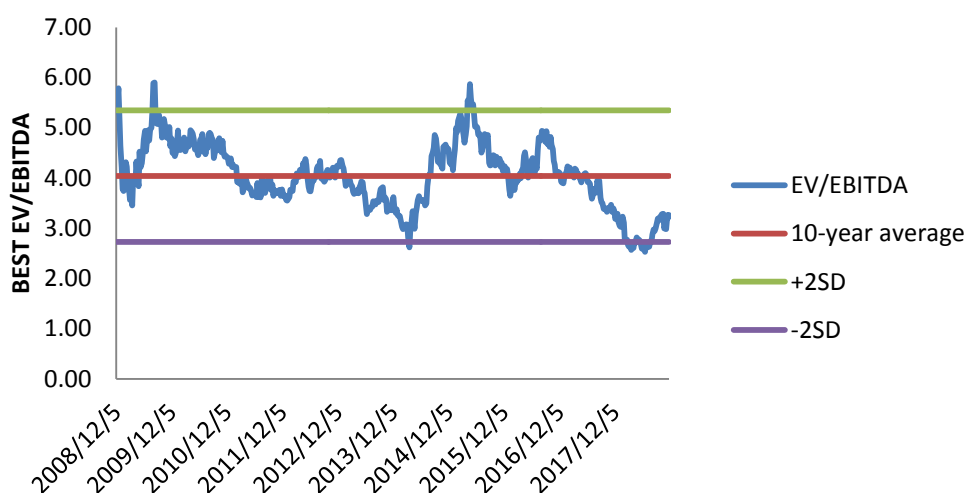
CM dividend yield with stable growth remain attractive. We forecast CM to deliver a dividend yield of ~4% in 2018, slightly higher than its long run average. We predict its EPS will record a low single digit growth with strong free cash flow for next 3 years, which can provide support to its DPS growth.

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Valuation

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Figure: CM's BEST EV/EBITDA



Source: Bloomberg, CASH

Key Risk

1. Reduction in CM's dividend value due to RMB depreciation;
2. More intense competition in the mobile market (drive down data revenue and put more pressure on China Mobile's pricing);
3. Faster-than-expected decline in voice revenues (CM is the market leader providing the widest voice call coverage in China, with voice contributing a larger part of total revenue compared with the other two operators);
4. CM acts as a tool of state policy and may be over-investing in 5G (but we think technology research in the early stage of network deployment gives them a competitive edge, coupled with free marketing in remote regions and better network coverage compared with peers, also overinvesting risk reduced after the establishment of China Tower);
5. Slowdown in 4G monetarization.

