

China Telecom28 Nov 2018China Mobile: Strong cash flow with scale advantage

Core competiveness 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.

CASH Research

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Senior Research Analyst Tel: (+852) 2287-8788 Tony.Cheung@cash.com. hk **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.

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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)	ТР	%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 COMMUNI	C 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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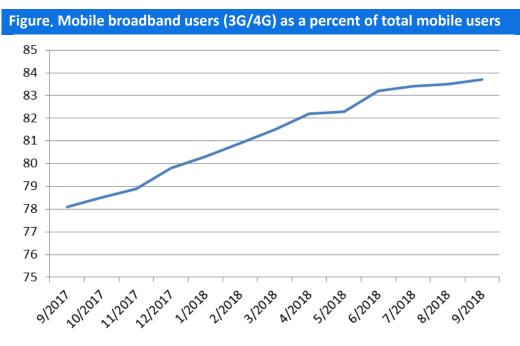
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The Telecom Industry

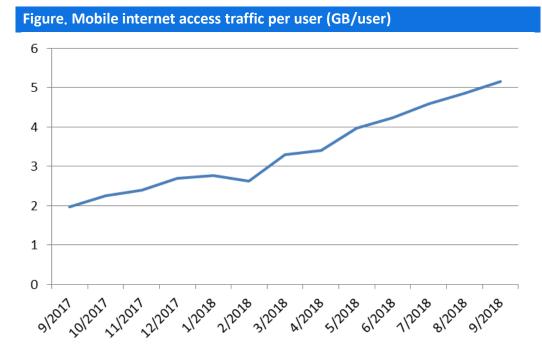
This listing of China Tower (788.HK) in 8 Aug 2018 was regarded as an upward rerating catalyst for the China Telecoms sector. But the bullish expectation failed to materialize. Market attention is likely to turn to 5G transition and competition in unlimited data plans. The initial set of specifications 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.

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Source: MIIT



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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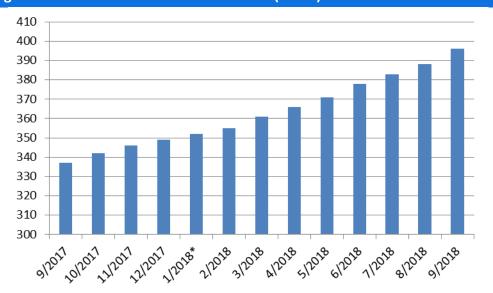


Figure: China fixed broadband subscribers (in mn)

Source: MIIT

Core competiveness of China Mobile

We believe China Mobile(00941) 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). Its business segments include telecom service (data/voice service) and sales of products and others. We think the **scale advantage** will allow CM to have a higher margin (2018E EBITDA margin:~37%, CU:~29% and CT:~28%)

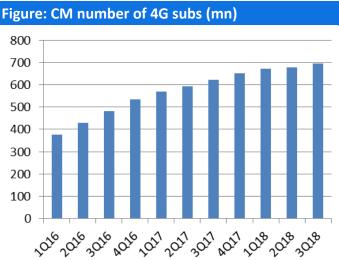
Positive signs of China Mobile

1. Number of subscribers is still growing

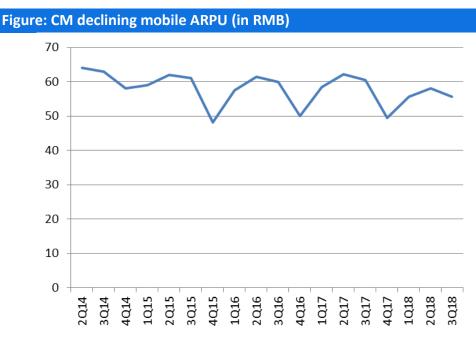
Due to the large presence in rural and regional areas, CM's mobile ARPU will continue to be negatively impacted by the cancellation of data roaming on a YoY basis until the end of 2Q19 (previously elimination of voice roaming tariffs played out by 3Q18). However, we think unlimited and high capacity 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.

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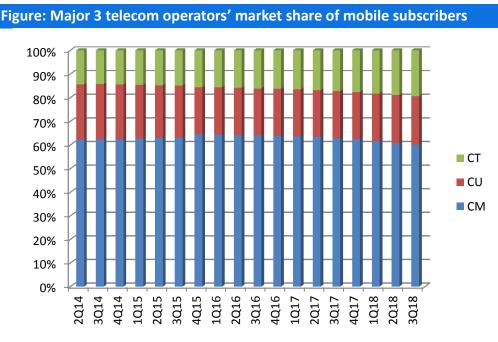
Source: China Mobile, CASH



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.

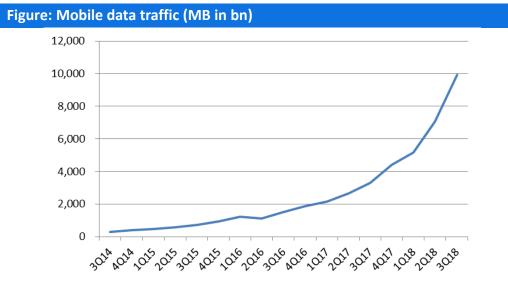
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Source: CM, CU, CT, CASH

2. Jump in mobile traffic also helps

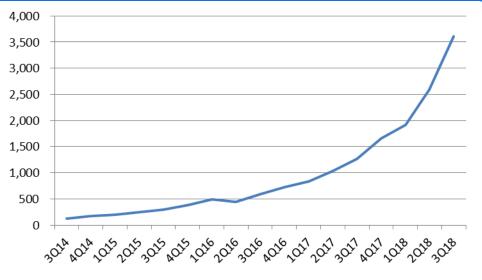
CM's mobile data traffic grew exponentially, driven by strong growth of data of usage (demand for sharing images, streaming music, high definition video or playing games, etc). Looking forward, considering that 5G will bring disruptive changes to the development of drones, connected cars, industrial 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.



Source: China Mobile, CASH

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

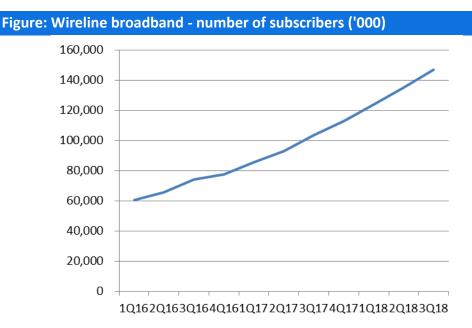


Source: China Mobile, CASH

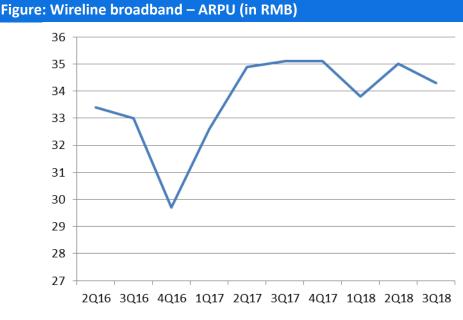
3. CM Fixed Broadband is a future bright spot

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.

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Source: China Mobile, CASH



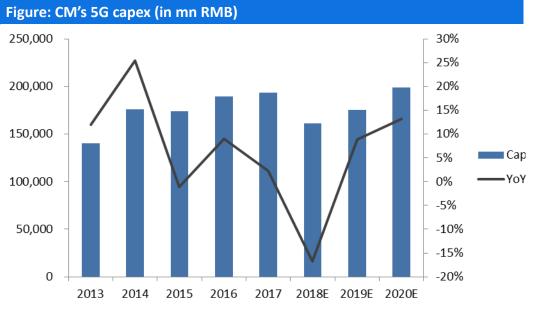
Source: China Mobile, CASH

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

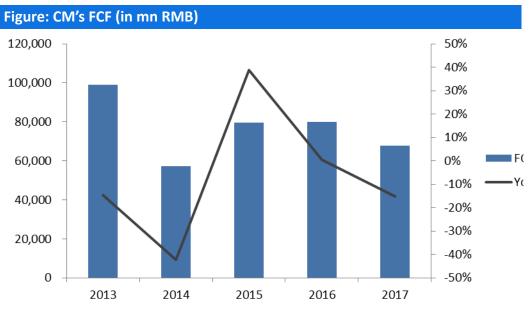
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Also, ramp up in 5G capex is likely to be slower than that of 4G which pick up fast at initial stage, since China Telecom operators initially focus on 5G outdoor coverage, along roads or areas for IoT and edge computing activities, with indoor coverage 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.



Source: China Mobile, CASH

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Source: China Mobile, CASH

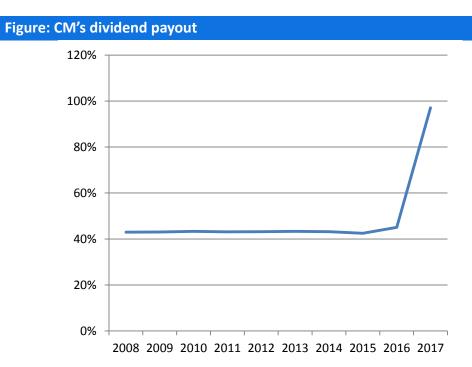
5. CM will be the biggest beneficiary in 5G

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 monetarization after 4G roll-out completion and higher demand from the government in improving SOE payout.

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Source: China Mobile, CASH



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

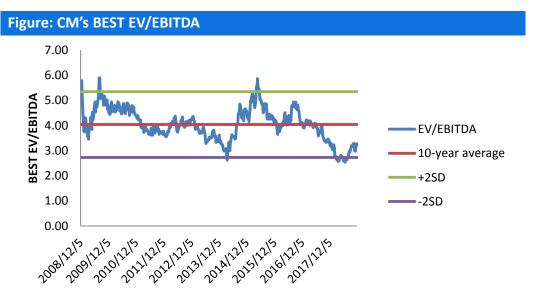
Source: Bloomberg, CASH

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

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 is attractive. We also like CM's highly defensive telecom business especially when economy may slow down.



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);
- 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.

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FY20E

296,700

345,001 24,395

10,844

91,611

768,550

132.499

802,799

35,343

586

68,213

1,807,990

8,646

276,836

321.683

607.165

1,809

0

3,250

China Mobile

941.HK, Buy, TargetPrice: 86

EV16

90,413

367,194

19,045

8,832

101.161

586,645

124.039

712,209

35,343

1,708

61,050

1,520,994

10,561

250,838

274,990

536.389

0

0

2,467

N/A

FY17

120.636

345,001

24,153

10,222

58,184

558,196

132.499

726,141

35,343

1,721

68,213

1,522,113

8,646

233,169

288.167

529.982

0

0

3,250

FY18E

188,235

345,001

22,635

10,061

85,002

650,934

132.499

734,899

35,343

1.202

68,213

1,623,090

8,646

256,864

298.475

563.985

580

0

3,250

FY19E

258,094

345,001

23,515

10,453

88,307

725,369

132.499

751,976

35,343

840

68,213

1,714,239

8,646

266,850

310.079

585.575

1,183

0

3,250

Balance Sheet (million RMB) Year-end 31 Dec

Cash & equivalents

Marketable securities

Accounts receivable

Other current assets

Total current assets

Other intangible assets

LT investments Fixed assets

Other LT assets

Accounts payable

Convertible debt

Other LT liabilities

Other current liabilities

Total current liabilities

Total assets

ST debt

LT debt

Goodwill

Inventories

Income Statement (million RMB)					
Year-end 31 Dec	FY16	FY17	FY18E	FY19E	FY20E
Revenue	708,421	740,514	767,962	797,818	827,674
SG&A	-590,333	-620,388	-636,663	-661,415	-686,166
Other expense	-57,493	-61,086	-57,835	-60,083	-62,332
Operating profit	118,088	120,126	131,299	136,403	141,508
EBITDA	256,677	270,421	284,332	295,209	306,133
Depreciation	-138,090	-149,780	-152,514	-158,443	-164,372
Amortization	-499	-515	-519	-362	-253
EBIT	118,088	120,126	131,299	136,403	141,508
Net interest expense	16,005	15,883	15,466	16,477	17,525
Associates & JCEs	8,636	9,949	9,949	9,949	9,949
Other income	1,733	2,179	2,179	2,179	2,179
Earnings before tax	144,462	148,137	158,893	165,008	171,161
Income tax	-35,623	-33,723	-37,676	-39,126	-40,585
Net profit After tax	108,839	114,414	121,216	125,881	130,575
Minority interests	-98	-135	-135	-135	-135
Other items	0	0	0	0	0
Preferred dividends	0	0	0	0	0
Normalised NPAT	108,741	114,279	121,081	125,746	130,440
Extraordinary items	0	0	0	0	0
Reported NPAT	108,741	114,279	121,081	125,746	130,440
Dividends	-48,993	-110,909	-54,553	-56,655	-58,770
Transfer to reserves	59,748	3,370	66,528	69,092	71,671
EPS	5.31	5.58	5.91	6.14	6.37
DPS	2.39	5.42	2.66	2.77	2.87
Cashflow statement (million RMB)				
Year-end 31 Dec	FY16	FY17	FY18E	FY19E	FY20E
Net income	108,741	114,279	121,081	125,746	130,440
Depreciation	138,090	149,780	152,514	158,443	164,372
Amortization	499	515	519	362	253
Change in Net Working Capital	55,311	-54,180	-8,864	-17,014	-17,014
Cashflow from operations	253,701	245,514	282,978	301,566	312,080
Capital expenditures	-189,366	-193,605	-161,272	-175,520	-215,195
Other non current assets	43,415	-15,636	0	0	0
Other non current liabilities	973	783	0	0	0
CF from investing acts	-194,523	-106,533	-161,272	-175,520	-215,195
CF after investing acts	59,178	138,981	121,706	126,046	96,885
Equity issue	25,561	20,308	-135	-135	-135
Debt issue	-1,710	-1,915	580	603	625
Convertible debt issue	0	0	0	0	0
Dividends	-48,993	-110,909	-54,553	-56,655	-58,770
CF from financial acts	-48,958	-108,231	-54,107	-56,187	-58,279
Net cashflow	10,220	30,750	67,599	69,859	38,606
Beginning cash	79,842	90,413	120,636	188,235	258,094
Adjustments	351	-527	0	0	0
Ending cash	90,413	120,636	188,235	258,094	296,700
Ending net debt	-79,852	-111,990	-179,008	-248,265	-286,245

Total liabilities 538,856 533,232 567,816 590,009 612,224 Minority interest 3,117 3,245 3,110 2,975 2,840 Preferred interest 0 0 0 0 0 402,130 402,130 402,130 402,130 Common stock 402,130 536.313 522.748 589.276 658.368 730.039 Retained earnings -110 909 -58 770 Proposed dividend -48 993 -54 553 -56 655 Other equity and reserves 40,578 60,758 60,758 60,758 60,758 Total shareholders' equity 982.138 988,881 1,055,274 1,124,231 1,195,767 Total equity & liabilities 1,520,994 1,522,113 1,623,090 1,714,239 1,807,990 Key Ratios FY16 FY17 FY18E FY19E FY20E Growth (%) EPS 1.9% 5.1% 6.0% 3.9% 3.7% Revenue 6.0% 4.5% 3.7% 3.9% 3.7% Profitability (%) EBITDA margin 36.2% 36.5% 37.0% 37.0% 37.0% EBIT margin 16.7% 16.2% 17.1% 17.1% 17.1% Net Margin 15.4% 15.5% 15.8% 15.8% 15.8% Effective tax rate 24.7% 22.8% 23.7% 23.7% 23.7% Dividend payout 45.1% 97.1% 45.1% 45.1% 45.1% ROE 10.9% 11.1% 11.6% 11.5% 11.2% ROA 7.1% 7.5% 7.5% 7.3% 7.2% Liquidity (x) Current ratio 1 09 1 05 1 1 5 1 24 1 27 Interest coverage N/A N/A N/A N/A N/A Leverage Net Debt/EBITDA (x) net cash net cash net cash net cash net cash Net Debt/Equity (%) net cash net cash net cash net cash net cash Activity (days) Days receivable N/A N/A N/A N/A N/A Days inventory N/A N/A N/A N/A N/A Days payable N/A N/A N/A N/A N/A

N/A

N/A

N/A

N/A

Source: Company data, CASH

Source: Company data, CASH

Cash cycle

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