



## ZTE (763 HK/000063 CH)

### New 5G projects will boost revenue

- We project ZTE's carriers' network revenue to grow by 12%/ 17%/ 10% YoY in FY19E-21E, respectively. ZTE won a number of new project bids from the Chinese telecom operators.
- Better product mix with high-end products helps lift gross profit margin. ZTE's gross margin is estimated to grow by 6.6ppt/ 0.9 ppt/ 1.1ppt to 38.0%/ 38.9%/ 40.0% in FY19-21E
- ZTE can benefit from the launch of 5G network in 2020 and new measures under the Speed Upgrade and Tariff Reduction policy in China
- Recommend **BUY** with TP of HK\$ 31.0 for **ZTE-H (763 HK)**, which implies 19.1x/ 15.3x FY20E/ FY21E P/E, and **BUY** for **ZTE-A (000063 CH)** with TP of RMB 42.0, equivalent to 28.7x/ 23.0x FY20E/21E P/E

**ZTE's Carriers' networks business boosted by new project bids and 5G network development in China.** ZTE has formed strategic partnerships with many domestic and international carrier operators to develop telecom network. We project carriers' network revenue to grow by 12%/ 17%/ 10% YoY in FY19E-21E, respectively.

**Gross profit margin to increase on better product mix.** ZTE's gross margin has benefited from higher contributions of 5G telecom equipment and smartphones. It is set to gain from increased contribution from the higher-margin 5G products. We expect gross margin to improve by 6.6ppt/ 0.9ppt/ 1.1ppt to 38.0%/ 38.9%/ 40.0% YoY in FY19E-21E, respectively.

**Solid growth from margin expansion and revenue growth.** ZTE is expected to benefit from the rapid 5G development in China with better network coverage. Net profit margin will improve to 5.1%/ 5.7%/ 6.6% in FY19E-21E, respectively.

**Valuation.** We recommend (1) **BUY** on **ZTE-H (763 HK)** with the TP of HK\$ 31.0, which implies 19.1x/ 15.3x FY20E/ FY21E P/E; (2) **BUY** on **ZTE-A (000063 CH)** with TP of RMB 42.0, which is equivalent to 28.7x/ 23.0x FY20E/ FY21E P/E.

#### Results and Valuation

FY ended Dec 31	FY17A	FY18A	FY19E	FY20E	FY21E
Revenue (RMB mn)	108,815	85,513	94,968	107,799	116,750
Chg (% YoY)	7.5	(21.4)	11.1	13.5	8.3
Net profit (RMB mn)	4,568	(6,984)	4,866	6,179	7,719
Chg (% YoY)	(293.8)	N/A	N/A	27.0	24.9
EPS (RMB)	1.090	(1.666)	1.160	1.462	1.826
Chg (% YoY)	(292.4)	N/A	N/A	27.0	24.9
BPS (RMB)	7.554	5.461	6.622	8.096	9.937
Chg (% YoY)	19.0	(27.7)	21.2	22.3	22.7
P/E (x) –H shr	20.6	(14.3)	20.8	16.7	13.3
P/E (x) –A shr	33.9	(22.2)	31.8	25.3	20.2
P/B (x)–H shr	3.0	4.4	3.7	3.0	2.5
P/B (x) –A shr	4.9	6.8	5.6	4.6	3.7
ROAE (%)	15.7	(25.6)	19.2	20.0	20.4
ROAA (%)	3.2	(5.1)	3.4	3.6	3.9

Note. Exchange rate assumption for FY20E-21E:: HKD 1 = RMB 0.900

Source(s): Bloomberg, ABCI Securities estimates

### Company Report

Rating (H): BUY

Rating (A): BUY

TP(H): HK\$ 31.0

TP(A): RMB 42.0

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Price (H/A shr)	27.05/ 36.92
Est. price return (H/A shr)	14.6%/ 13.8%
Est. dividend yield (H/A shr)	0.0%/ 0.0%
Est. total return (H/A shr)	14.6%/ 13.8%
Last Rating & TP (H/A shr)	BUY, HK\$26.0
	BUY, RMB37.0

Previous Report Date Nov 19, 2019

Source(s): Bloomberg, ABCI Securities

#### Key Data:

52Wk H/L (HK\$) (H shr)	27.70/ 14.98
52Wk H/L (RMB) (A shr)	38.50/ 19.67
Total issued shares (mn)	
Issued H shr (mn)	755.5
Issued A shr (mn)	3,472.0
H-shr market cap (HK\$ mn)	20,436.3
A-shr market cap (RMB mn)	128,186.2

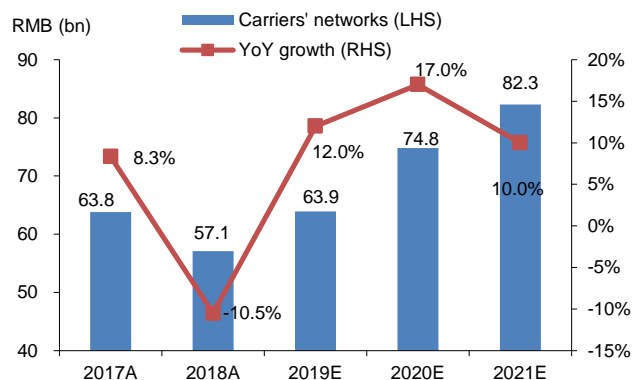
Major shareholder(s) :	
Zhongxingxin	27.4%
Central Huijin Asset Management	1.25%
Hunan Nantian	1.0%

Source(s): Company, ABCI Securities



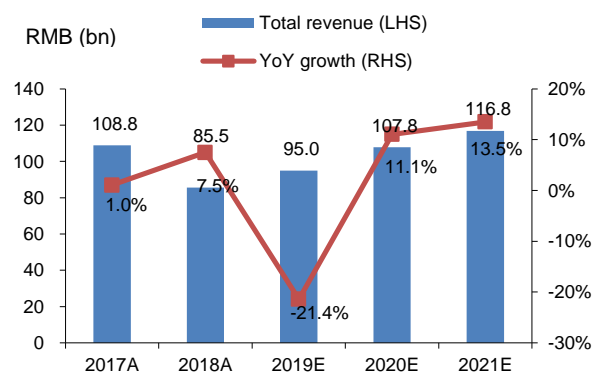
Chinese telecom operators have established 130,000 5G base stations in 2019, covering over 50 cities. For 2020E, we forecast over 600,000 new 5G base stations will be built. Leveraging the Group's technological innovations and telecom expertise, ZTE will be benefiting from the massive 5G network development in China. In Jan 2020, ZTE has won a project bid (for providing Network Function Virtualization NFV network equipment; the project will cover 12 provinces in total) from China Mobile (941 HK) and another (10G PON equipment) from China Unicom (762 HK). We believe the shipments of ZTE's 5G massive MIMO products would significantly improve in 2020. The proliferation of IPTV, online education, online games and high quality video has driven up demand of fiber optics network in China; also, MIIT has proposed to improve the network coverage in China to reach over 98% by end-2020. We project ZTE's carriers' network revenue to grow by 12%/ 17%/ 10% YoY in FY19E-21E, respectively, representing a CAGR of 13% in FY18-21E. We forecast proportion of carrier's business revenue to increase from 66.8% in FY18 to 67.3% in FY19E and 69.4% in FY20E.

**Exhibit 1: ZTE's carriers' network revenue and YoY growth**



Source(s): Company, ABCI Securities estimates

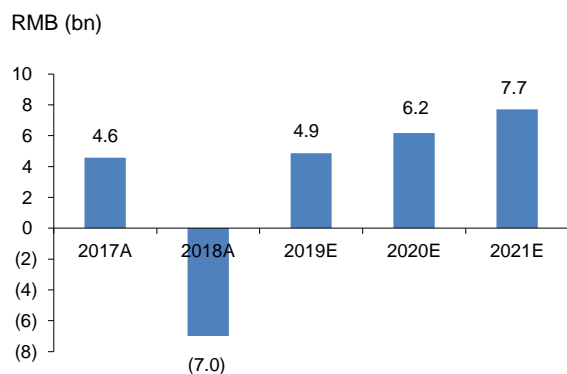
**Exhibit 2: ZTE's total revenue and YoY growth**



Source(s): Company, ABCI Securities estimates

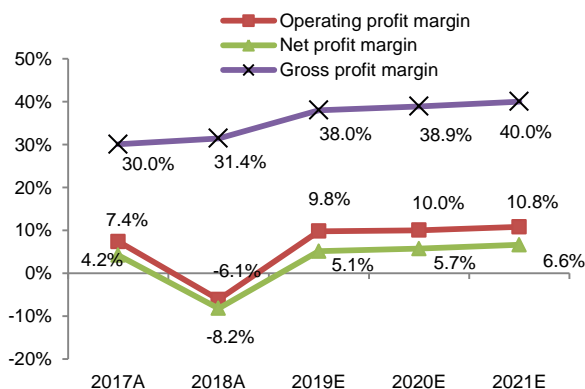
Growth in global smartphone shipments in 3Q19 was mild at 0.8% YoY, for which the global smartphone shipments are transiting towards the 5G-driven demand. In 2020, the global smartphone shipments are expected to rebound, driven by 5G smartphones demand. ZTE has introduced a new 5G smartphone Axon 10s Pro in 1Q20; the model is compatible to both 5G SA and NSA modes. Thanks to the recovery of electronic supply chain earlier hampered by US sanctions, we expect a solid rebound in ZTE's smartphone business in 2020. The Group is also carrying out a series of brand-building campaigns and activities to improve brand recognition.

**Exhibit 3: ZTE's net profit**



Source(s): Company, ABCI Securities estimates

**Exhibit 4: ZTE's profit margins**



Source(s): Company, ABCI Securities estimates



Driven by the better product mix with a higher proportion of 5G products, ZTE's gross margin is estimated to grow by 6.6ppt/ 0.9 ppt/ 1.1ppt to 38.0%/ 38.9%/ 40.0% in FY19-21E, respectively. Thanks to the recovery of component supply chain and gross margin improvement, we expect net profit margin to improve to 5.1%/ 5.7%/ 6.6% in FY19-21E, respectively.

**Exhibit 5: Changes in our financial estimates**

(RMB mn)	OLD			NEW			CHANGE		
	FY19E	FY20E	FY21E	FY19E	FY20E	FY21E	FY19E	FY20E	FY21E
Revenue	92,652	105,067	112,152	94,968	107,799	116,750	2.5%	2.6%	4.1%
Operating profit	9,039	10,502	12,064	9,319	10,807	12,607	3.1%	2.9%	4.5%
Net Profit	4,711	5,976	7,337	4,866	6,179	7,719	3.3%	3.4%	5.2%

Source(s): Company, ABCI Securities estimates

**Recommend BUY ZTE- H / A (763 HK/000063 CH)**

Our valuations for ZTE-H/A (763 HK/000063 CH) are based on DCF model (WACC: 13.0%/12.8%; D/ (D+E) =18.9%/18.3%; perpetuity growth rate of 2%/2%). We recommend **BUY** for both H / A shr with TP at HK\$ 31.0/RMB 42.0. The H-shr TP implies 19.1x/ 15.3x FY20E/ FY21E P/E for the H-shr, while A-shr TP is equivalent to 28.7x/ 23.0x FY20E/ FY21E P/E.

**Exhibit 6: Peer Comparison**

			P/E				P/B				ROE	ROA	EV/ EBITDA
	Ticker	Price*	18A	19E	20E	21E	18A	19E	20E	21E	20E	20E	20E
<u>H-shr market</u>													
ZTE	763 HK	27.05	n.a.	22.0	19.1	15.5	4.4	3.2	2.8	2.5	15.5	3.8	16.3
COMBA	2342 HK	2.30	n.a.	30.9	16.6	11.8	1.7	1.6	1.4	1.3	8.2	2.6	n.a.
Xiaomi	1810 HK	11.68	11.9	22.9	19.1	15.7	3.5	3.0	2.6	2.2	15.7	7.0	15.4
Simple Avg.			11.9	25.3	18.3	14.3	3.2	2.6	2.3	2.0	13.1	4.5	15.8
Weighted Avg.			11.9	22.7	19.1	15.6	3.8	3.1	2.7	2.3	15.5	5.8	15.7
<u>A-shr market</u>													
ZTE	000063 CH	36.92	n.a.	31.5	25.5	20.3	7.0	5.0	4.1	3.5	16.3	4.3	15.5
Shenzhen Sunway Communicat-A	300136 CH	46.35	44.9	41.3	31.3	24.1	12.1	9.3	7.2	5.6	24.3	15.3	23.5
Hengtong Optic-Electric Co-A	600487 CH	17.86	13.9	20.3	15.2	12.1	2.8	2.5	2.2	1.9	13.5	5.3	n.a.
Accelink Technologies Co -A	002281 CH	31.25	60.3	55.4	40.9	32.7	5.9	5.3	4.9	4.3	12.1	6.4	30.1
Hubei Kaile Science & Tech-A	600260 CH	14.26	16.0	13.2	10.5	8.3	2.6	2.2	1.8	1.5	17.6	n.a.	n.a.
Tongding Interconnection I-A	002491 CH	7.00	15.6	26.9	20.6	26.9	1.7	n.a.	n.a.	n.a.	4.1	2.5	n.a.
Simple Avg.			30.1	31.4	24.0	20.7	5.3	4.9	4.0	3.4	14.7	6.7	23.0
Weighted Avg.			33.4	32.4	25.4	20.4	6.8	5.3	4.3	3.6	16.6	6.4	18.6

Based on closing price on Jan 15, 2020

Source(s): Bloomberg



**農銀國際**

ABC INTERNATIONAL

ABCI SECURITIES COMPANY LIMITED

ZTE (763 HK / 000063 CH)

China Telecom Sector

Jan 15, 2020

## **Risk factors**

### **The US Sanction policy**

ZTE's products rely on suppliers for key components. The US may re-implement the sanction policy against ZTE, banning the US suppliers from selling and distributing components to the Group. In our financial model, we do not factor in further penalty from 2019 onward.

### **Trade tension between the US and China trade tension**

The Group's business may be affected if trade tension between the US and China intensifies.

### **Slowdown in China's 5G development**

Any delays or slowdown in 5G network development in China would negatively impact ZTE's revenue.



## Financial Statements

### Consolidated income statement (2017A-2021E)

FY Ended Dec 31 (RMB mn)	2017A	2018A	2019E	2020E	2021E
Carriers' networks	63,782	57,076	63,925	74,792	82,271
Government & Corporate business	9,831	9,228	10,104	10,812	11,374
Consumer business	35,202	19,210	20,938	22,195	23,105
<b>Total revenue</b>	<b>108,815</b>	<b>85,513</b>	<b>94,968</b>	<b>107,799</b>	<b>116,750</b>
Gross profit	32,699	26,875	36,088	41,934	46,700
Other income and gains	6,951	4,248	4,035	3,834	3,642
R&D costs	(12,962)	(10,906)	(11,586)	(13,690)	(15,411)
Selling and distribution expenses	(12,260)	(9,085)	(9,022)	(10,564)	(11,091)
Administrative expenses	(3,238)	(4,106)	(4,312)	(4,570)	(4,936)
Others	(112,000)	(97,764) <sup>a</sup>	(100,852)	(113,934)	(123,047)
<b>Operating Profits</b>	<b>8,005</b>	<b>(5,224)</b>	<b>9,319</b>	<b>10,807</b>	<b>12,607</b>
Finance cost	(1,158)	(1,329)	(1,719)	(1,543)	(1,385)
Share of profits and losses of associates	(128)	(797)	(757)	(720)	(684)
<b>Profit before tax</b>	<b>6,719</b>	<b>(7,350)</b>	<b>6,843</b>	<b>8,544</b>	<b>10,538</b>
Tax	(1,333)	401	(1,252)	(1,564)	(1,928)
<b>Profit after tax</b>	<b>5,386</b>	<b>(6,949)</b>	<b>5,590</b>	<b>6,981</b>	<b>8,610</b>
Minority interests	(317)	383	(308)	(384)	(474)
Perpetual capital instruments	(501)	(417)	(417)	(417)	(417)
<b>Net profit</b>	<b>4,568</b>	<b>(6,984)</b>	<b>4,866</b>	<b>6,179</b>	<b>7,719</b>
<b>Adjusted net profit<sup>b</sup></b>	<b>9,324</b>	<b>2,492</b>	<b>9,560</b>	<b>11,162</b>	<b>13,003</b>
<b>EPS (RMB)</b>	<b>1.090</b>	<b>(1.666)</b>	<b>1.160</b>	<b>1.462</b>	<b>1.826</b>
<b>Adjusted EPS (RMB)</b>	<b>2.226</b>	<b>0.594</b>	<b>2.280</b>	<b>2.640</b>	<b>3.076</b>

<sup>a</sup> In FY18, there was USD1 bn related to penalty cost in Others item.

<sup>b</sup> Adjusted net profit = net profit excluding investment gains and non-operating expenses

Source(s): Company, ABCI Securities estimates



Consolidated balance sheet (2017A-2021E)

As of Dec 31 (RMB mn)	2017A	2018A	2019E	2020E	2021E
PPE	10,202	10,194	11,180	11,558	12,320
Investments in JV And associates	3,961	3,015	2,143	1,737	1,414
Intangible assets	5,363	6,270	8,607	10,089	11,548
Others	16,176	16,870	12,202	12,431	12,687
<b>Total non-current assets</b>	<b>35,703</b>	<b>36,350</b>	<b>34,132</b>	<b>35,815</b>	<b>37,969</b>
Cash & cash equivalents	30,109	21,134	48,456	67,831	92,360
Inventories	26,234	25,011	26,262	27,575	28,954
Receivables	38,378	30,061	31,949	33,957	36,091
Others	13,538	16,794	17,249	17,792	18,406
<b>Total current assets</b>	<b>108,260</b>	<b>93,001</b>	<b>123,916</b>	<b>147,155</b>	<b>175,811</b>
<b>Total assets</b>	<b>143,962</b>	<b>129,351</b>	<b>158,049</b>	<b>182,971</b>	<b>213,780</b>
Bank borrowings	18,536	24,983	34,977	31,479	28,331
Payables	35,047	27,977	26,626	25,344	24,129
Others	34,012	36,417	50,681	73,258	99,696
<b>Total current liabilities</b>	<b>87,595</b>	<b>89,377</b>	<b>112,284</b>	<b>130,081</b>	<b>152,156</b>
Bank borrowings	3,002	2,367	2,319	1,995	1,715
Others	7,985	4,647	4,784	4,947	5,134
<b>Total non-current liabilities</b>	<b>10,987</b>	<b>7,013</b>	<b>7,103</b>	<b>6,942</b>	<b>6,849</b>
<b>Total liabilities</b>	<b>98,582</b>	<b>96,390</b>	<b>119,387</b>	<b>137,022</b>	<b>159,005</b>
Shareholders' equity	31,647	22,898	27,763	33,942	41,661
Others	13,733	10,063	10,899	12,006	13,114
<b>Total equity</b>	<b>45,380</b>	<b>32,961</b>	<b>38,662</b>	<b>45,948</b>	<b>54,775</b>

Source(s): Company, ABCI Securities estimates



Consolidated Cash Flow Statement (2017A-2021E)

As of Dec 31 (RMB mn)	2017A	2018A	2019E	2020E	2021E
Operating profit before change in working capital	9,903	2,245	32,971	37,624	42,923
Change in working capital	(3,189)	(10,072)	(7,962)	(6,362)	(6,401)
Others	(2,254)	(2,406)	(3,801)	(3,903)	(4,080)
<b>Operating cash flow</b>	<b>4,460</b>	<b>(10,233)</b>	<b>21,208</b>	<b>27,359</b>	<b>32,442</b>
CAPEX	(2,340)	(2,388)	(2,602)	(2,837)	(3,092)
Others	(1,711)	277	(1,441)	(1,502)	(1,548)
<b>Investing cash flow</b>	<b>(4,052)</b>	<b>(2,111)</b>	<b>(4,043)</b>	<b>(4,339)</b>	<b>(4,640)</b>
Bank loans	35,148	29,124	9,946	(3,822)	(3,427)
Others	(35,031)	(26,073)	(43)	(27)	(9)
<b>Financing cash flow</b>	<b>117</b>	<b>3,051</b>	<b>9,903</b>	<b>(3,849)</b>	<b>(3,436)</b>
<b>Net increase in cash and cash equivalents</b>	<b>526</b>	<b>(9,293)</b>	<b>27,068</b>	<b>19,171</b>	<b>24,366</b>
Cash and cash equivalents at beginning of year	30,050	30,109	21,134	48,456	67,831
Others	(466)	318	254	203	163
<b>Cash and cash equivalents at end of year</b>	<b>30,109</b>	<b>21,134</b>	<b>48,456</b>	<b>67,831</b>	<b>92,360</b>
<b>Financial Ratio:</b>					
Gross profit margin	30.0%	31.4%	38.0%	38.9%	40.0%
Operating profit margin	7.4%	-6.1%	9.8%	10.0%	10.8%
Net profit margin	4.2%	-8.2%	5.1%	5.7%	6.6%
Adjusted net profit margin	8.6%	2.9%	10.1%	10.4%	11.1%
ROAE (%)	15.7%	-25.6%	19.2%	20.0%	20.4%
ROAA (%)	3.2%	-5.1%	3.4%	3.6%	3.9%
<b>YoY Growth:</b>					
Revenue	7.5%	-21.4%	11.1%	13.5%	8.3%
Operating profit	2233.1%	-165.3%	-278.4%	16.0%	16.7%
Net profit	-293.8%	-252.9%	-169.7%	27.0%	24.9%
Adjusted net profit	22.4%	-73.3%	283.6%	16.8%	16.5%

Source(s): Company, ABCI Securities estimates



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Rating	Definition
Buy	Stock return rate $\geq$ Market return rate (10%)
Hold	- Market return rate (-10%) $\leq$ Stock return rate $<$ Market return rate (+10%)
Sell	Stock return $<$ - Market return (-10%)

Stock return rate: expected percentage change of share price plus gross dividend yield over the next 12 months

Market return rate: average market return rate since 2008 (HSI total return index 2008-19 CAGR at 10%)

Time horizon of share price target: 12-month

Stock rating, however, may vary from the stated framework due to factors including but not limited to: corporate governance, market capitalization, historical price volatility relative to corresponding benchmark index, average daily turnover of the stock relative to market capitalization of the stock, competitive advantages in corresponding industry, etc.

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