China Telecom Corporation Ltd. (728 HK)

Strong mobile user growth, upgrade to BUY

- Solid service revenue growth with strong mobile user addition
- Thanks to scale effect with strong mobile user growth, we estimate profit margin to improve in 2020.
- Team up with China Unicom to co-share and co-build 5G network
- Recommend **BUY** with TP of HK$ 3.50, which implies 2.4x/ 2.3x FY19E/ FY20E EV/EBITDA.

Company Report

Dec 11, 2019

Rating: BUY

TP: HK$ 3.50

Analyst : Ricky Lai
Tel: (852) 2147 8895
rickylai@abci.com.hk

Robust mobile user growth. We project China Telecom's mobile users to grow by 13.2%/ 8.2%/ 6.2% in FY19-21E, respectively. The Group has launched a larger variety of telecom service products, such as bundled services packages, smart home services, internet SIM cards, etc., than other operators.

Strong mobile service revenue growth. China Telecom was the only telecom operator to record a positive growth in mobile service revenue in 9M19 (+2.5% YoY, vs. -1.0% for China Mobile (941 HK) and -5.6% for China Unicom (762 HK). We estimate China Telecom's service revenue to grow by 3.1%/ 3.5%/ 2.7% in FY19E-21E, respectively. Net margin is expected to edge up by 0.3ppt each in FY20 / 21E to 5.9% / 6.2%.

Benefiting from co-shared and co-built 5G network with China Unicom. China Telecom is expected to spend RMB 9bn to build 40,000 of 5G base stations in 2019. The Group has also teamed up with China Unicom to co-share and co-build 5G network, which will enable a more extensive network coverage.

Valuation. Upgrade to **BUY** rating on China Telecom with the TP of HK$3.50, implying 2.4x/ 2.3x FY19E/ FY20E EV/EBITDA.

Results and Valuation

FY ended Dec 31	FY17A	FY18A	FY19E	FY20E	FY21E
Revenue (RMB mn)	366,229	377,124	382,528	393,749	402,776
Chg (%,YoY)	3.9	3.0	1.4	2.9	2.3
Net profit (RMB mn)	18,617	21,210	21,374	23,308	24,878
Chg (%,YoY)	3.3	13.9	0.8	9.0	6.7
EPS (RMB)	0.23	0.26	0.26	0.29	0.31
Chg (%,YoY)	3.3	13.9	0.8	9.0	6.7
BPS (RMB)	4.03	4.24	4.40	4.58	4.77
Chg (%,YoY)	3.3	5.3	3.7	4.1	4.2
P/E (x)	10.9	10.1	10.3	9.4	8.8
P/B (x)	0.62	0.62	0.62	0.59	0.57
ROE (%)	5.8	6.3	6.1	6.4	6.6
ROA (%)	2.8	3.2	3.2	3.5	3.6
DPS (RMB)	0.09	0.11	0.11	0.12	0.12
Dividend Yield (%)	2.6	3.2	3.2	3.5	3.7

*Exchange rate assumption for FY19E-21E: HKD 1 = RMB 0.900
Source(s): Bloomberg, ABCI Securities estimates

Share price (HK$)	3.01
Est. share price return	16.3%
Est. dividend yield	3.2%
Est. total return	19.5%
Previous Rating & TP	HOLD/HK$4.0
Previous Report Date	Jan 15, 2019

Source(s): Bloomberg, ABCI Securities

Key Data

52Wk H/L(HK$)	4.5/3.3
Issued shares (mn)	80,932.0
Market cap (HK$ mn)	243,605
Avg daily turnover (HK$ mn)	392
Major shareholder(s)	
China Telecom Cop.	70.9%
JP Morgan	12.0%
Citigroup	8.0%

Source(s): Company, ABCI Securities

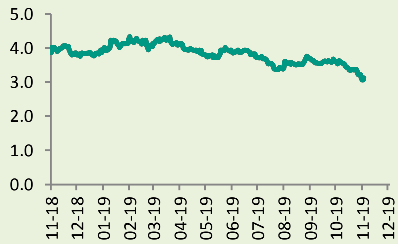
Share Performance (%)

	Absolute	Relative*
1-mth	(14.0)	(13.9)
3-mth	(12.1)	(13.5)
6-mth	(17.4)	(13.9)

*Relative to HSI

Source(s): Bloomberg, ABCI Securities

Share performance (HK$)



Source(s): Bloomberg, ABCI Securities

China Telecom's net profit in 9M19 was down 3.4% YoY on cancellation of data roaming fee and the lower mobile service tariff. Excluding the one-off disposal gain from China Tower (788 HK) in 3Q18, net profit would rise 2.5% YoY. EBITDA margin improved 3.4ppt YoY to 33.9% in 3Q19; mobile ARPU was RMB 46.6, similar to 2018.

Service revenue grew 2.5% YoY in 9M19, outpacing other telecom operators in China (China Mobile: -1.0%; China Unicom: -5.6%), mainly driven by strong mobile user growth. China Telecom added 27.4mn of mobile users in 9M19, the highest among telecom operators in China (China Mobile's:+17.0mn; China Unicom: +9.7mn), indicating the Group strong ability to retain mobile users.

Exhibit 1: Telecom operators' 9M19 operational data comparison table

	China Mobile	China Unicom	China Telecom
Service revenue growth (YoY)	-1.0%	-5.6%	2.5%
EBITDA growth (YoY)	5.3%	10.4%	13.8%
EBITDA margin	39.8%	36.8%	33.9%
Net profit growth (YoY)	-13.9%	11.9%	-3.4%
Mobile user additions (mn)	17.0	9.7	27.4
4G user additions (mn)	30.1	32.2	32.9
ARPU (RMB)	50.2	40.6	46.6

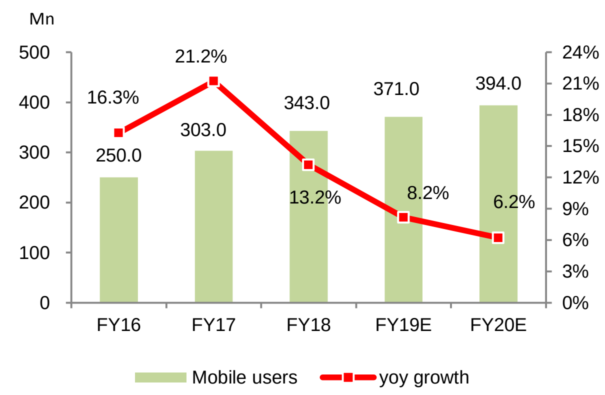
Source(s): the Companies

The Group's ability to gain mobile customers would remain strong in 2020, thanks to its cooperation with China Unicom and internet companies as well as the launch of telecom products. The Group has launched more telecom service products, which include bundled services packages, smart home services, internet SIM cards, etc., than other operators. We project its mobile users to grow by 13.2%/ 8.2%/ 6.2% to 343 mn/ 371mn/ 394mn in FY19-21E, respectively.

Teaming up with China Unicom to co-share and co-build 5G network would allow the Group to expedite its 5G network development with less investment capital. China Telecom plans to spend RMB 9bn for building 40,000 5G base stations in 2019; we estimate its total number of 5G base stations would surpass China Mobile's. Thanks to the large mobile user base, which enables the economies of scale, and robust user growth, we estimate China Telecom's net margin to grow 0.3ppt/ 0.3ppt to 5.9%/ 6.2% in FY20-21E, respectively.

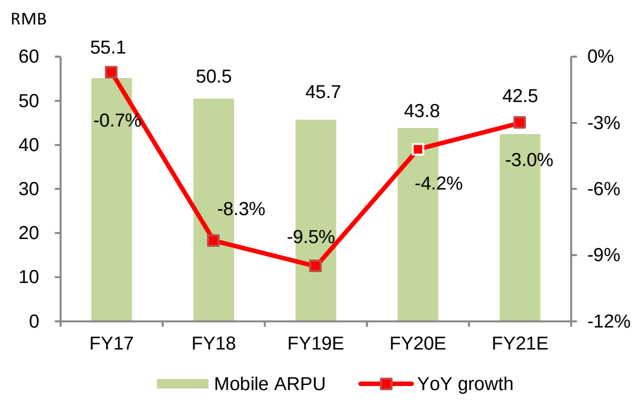
Based on our revision of mobile users forecast, we revise up net profit by 2.5%/3.0%/3.3% in FY19-21E, respectively.

Exhibit 2: China Telecom's mobile users and growth



Source(s): Company, ABCI Securities estimates

Exhibit 3: China Telecom's mobile ARPU and growth



Source(s): Company, ABCI Securities estimates

Exhibit 4: Changes in our financial estimates

	OLD			NEW			CHANGE		
(RMB mn)	FY19E	FY20E	FY21E	FY19E	FY20E	FY21E	FY19E	FY20E	FY21E
Revenue	371,386	380,618	387,657	382,528	393,749	402,776	3.0%	3.5%	3.9%
Operating profit	28,566	30,848	32,169	29,366	31,835	33,391	2.8%	3.2%	3.8%
Net Profit	20,853	22,629	24,083	21,374	23,308	24,878	2.5%	3.0%	3.3%

Source(s): Company, ABCI Securities estimates

Upgrade to BUY with TP at HK$3.50

We derive the Group's valuation (HK$283.3 bn) based on DCF model analysis (WACC: 12.8%; D/ (D+E) =30.8%; perpetuity growth rate: 2%). We lower the TP from HK$ 4.00 to HK$ 3.50 in view of the present sector valuation. Due to the stock's potential return of 19.5%, we recommend **BUY** with TP at HK$ 3.50, representing 2.4x/ 2.3x FY19E/ FY20E EV/EBITDA.

Exhibit 5: Peer Comparison Table

			P/E				P/B				ROE	ROA	EV/EBITDA
	Ticker	Price*	17A	18A	19E	20E	17A	18A	19E	20E	19E	19E	19E
<u>China Market</u>													
China Unicom	762 HK	6.86	105.2	26.3	16.7	12.3	0.7	0.7	0.7	0.6	4.2	2.2	2.2
China Mobile	941 HK	60.00	12.4	12.3	12.2	11.8	1.4	1.4	1.3	1.2	10.7	7.0	3.2
China Telecom	728 HK	3.01	15.3	14.0	12.9	11.8	0.8	0.8	0.8	0.8	6.4	3.5	3.0
China Tower	788 HK	1.62	n.a.	77.4	40.8	27.2	1.2	1.2	1.0	0.9	3.0	1.4	6.6
Simple Average			44.3	32.5	20.7	15.8	1.0	1.0	0.9	0.9	6.1	3.5	3.8
Weighted Average			23.5	20.7	15.8	13.4	1.2	1.2	1.1	1.1	8.7	5.5	3.4
<u>US Market</u>													
AT&T	T US	38.06	6.5	8.8	8.6	8.5	1.3	1.3	1.2	1.2	15.5	4.1	6.3
Verizon	VZ US	61.23	7.9	12.4	12.3	12.2	5.5	4.5	3.7	3.2	32.5	7.6	7.0
Sprint	S US	5.34	n.a.	3.4	167.6	113.8	1.3	1.0	0.9	0.9	0.8	0.1	5.1
T-Mobile	TMUS	75.02	12.8	20.6	17.5	14.7	2.6	2.3	2.0	1.9	12.4	5.9	6.3
Simple Average			9.0	11.3	51.5	37.3	2.7	2.3	2.0	1.8	15.3	4.4	6.2
Weighted Average			7.8	11.4	18.7	15.7	3.3	2.8	2.4	2.1	21.9	5.6	6.6

*Based on closing price on Dec 10, 2019
Source(s): Bloomberg, ABCI Securities

Financial Statements

Consolidated income statement (2017A-2021E)

FY Ended Dec 31 (RMB mn)	2017A	2018A	2019E	2020E	2021E
Service revenue	331,044	350,434	361,334	373,967	384,132
Sales of products and others	35,185	26,690	21,194	19,781	18,644
Total revenue	366,229	377,124	382,528	393,749	402,776
D&A	(74,951)	(75,493)	(76,964)	(79,281)	(84,202)
Network operation & support	(103,969)	(116,062)	(115,627)	(114,958)	(113,319)
Selling G&A	(58,434)	(59,422)	(61,204)	(62,291)	(63,155)
Personnel expenses	(56,043)	(59,736)	(61,427)	(62,378)	(63,766)
Other operating expenses	(45,612)	(37,697)	(37,940)	(43,006)	(44,943)
Total operating expenses	(339,009)	(348,410)	(353,162)	(361,914)	(369,386)
Operating Profits	27,220	28,714	29,366	31,835	33,391
Investment income	147	38	23	25	27
Share of profit from associates	877	2,104	1,473	1,546	1,624
Net finance costs	(3,291)	(2,708)	(2,496)	(2,474)	(2,026)
Profit before tax	24,953	28,148	28,365	30,932	33,016
Tax	(6,192)	(6,810)	(6,863)	(7,484)	(7,988)
Profit after tax	18,761	21,338	21,503	23,448	25,028
Minority interests	(144)	(128)	(129)	(141)	(150)
Shareholders' net profit	18,617	21,210	21,374	23,308	24,878
EBITDA	102,169	104,204	106,326	111,116	117,593
EPS (RMB)	0.230	0.262	0.264	0.288	0.307
DPS (RMB)	0.093	0.107	0.106	0.116	0.124

Source(s): Company, ABCI Securities estimates

Consolidated balance sheet (2017A-2021E)

As of Dec 31 (RMB mn)	2017A	2018A	2019E	2020E	2021E
PPE	406,257	407,795	417,599	424,145	422,950
CIP	73,106	66,644	63,312	53,815	45,743
Land lease prepayments	22,262	21,568	22,215	21,104	20,049
Goodwill	29,920	29,922	29,921	29,922	29,923
Intangible costs	12,391	14,161	15,011	15,761	16,549
Interest in associates	35,726	38,051	34,909	37,746	40,726
Other non-current assets	9,982	12,236	14,420	9,927	9,551
Total non-current assets	589,644	590,377	597,386	592,421	585,490
Cash & cash equivalents	19,410	16,666	14,345	25,026	42,508
Deposits in bank	3,100	6,814	6,610	6,411	6,219
Accounts receivables	22,096	20,475	20,885	21,302	21,728
Others	26,944	29,050	29,898	31,783	33,795
Total current assets	71,550	73,005	71,737	84,522	104,249
Total assets	661,194	663,382	669,123	676,943	689,739
Short term debt	54,558	49,537	34,676	27,741	22,193
Accounts payable	119,321	107,887	112,202	117,813	123,703
Accrued expenses and other payable	98,695	43,497	45,672	47,955	50,353
Others	2,834	57,999	53,175	49,354	46,253
Total current liabilities	275,408	258,920	245,726	242,863	242,502
Long term debt and payable	48,596	44,852	35,882	28,705	22,964
Deferred revenue	8,010	13,138	14,511	16,007	17,605
Others	2,483	2,373	16,317	17,953	19,708
Total non-current liabilities	59,089	60,363	66,709	62,665	60,277
Total liabilities	334,497	319,283	312,435	305,528	302,779
Equity attributable to shareholders	325,867	343,069	355,814	370,521	386,019
Non-controlling interests	830	1,030	874	894	941
Total equity	326,697	344,099	356,688	371,415	386,960

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	106,236	102,794	108,433	113,162	119,583
Change in working capital	(1,897)	4,053	4,669	5,520	5,796
Others	(3,211)	(2,923)	(2,852)	(2,805)	(2,312)
Tax	(4,626)	(4,626)	(4,626)	(4,626)	(4,626)
Operating cash flow	96,502	99,298	105,625	111,251	118,442
CAPEX	(87,334)	(74,940)	(78,000)	(80,340)	(82,750)
Others	2,071	(11,014)	2,464	2,472	2,481
Investing cash flow	(85,263)	(85,954)	(75,536)	(77,868)	(80,270)
Dividend paid	(7,530)	(7,568)	(8,629)	(8,601)	(9,379)
Others	(8,617)	(8,715)	(23,929)	(14,213)	(11,396)
Financing cash flow	(16,147)	(16,283)	(32,558)	(22,815)	(20,776)
Net increase in cash & cash equivalents	(4,908)	(2,939)	(2,469)	10,568	17,396
Cash & cash equivalents at beginning of year	24,617	19,410	16,666	14,345	25,026
Effect of changes in foreign exchange rate	(299)	195	148	113	86
Cash & cash equivalents at end of year	19,410	16,666	14,345	25,026	42,508
Financial Ratios:					
EBITDA margin (%)	30.9	29.7	29.4	29.7	30.6
Operating margin (%)	8.2	8.2	8.1	8.5	8.7
Net profit margin (%)	5.1	5.6	5.6	5.9	6.2
ROE (%)	5.8	6.3	6.1	6.4	6.6
ROA (%)	2.8	3.2	3.2	3.5	3.6
YoY Growth:					
Service revenue (%)	6.9	5.9	3.1	3.5	2.7
EBITDA (%)	7.4	2.0	2.0	4.5	5.8
Net profit (%)	3.3	13.9	0.8	9.0	6.7

Source(s): Company, ABCI Securities estimates

Disclosures

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Definition of equity rating

Rating	Definition
Buy	Stock return rate≥ Market return rate (10%)
Hold	- Market return rate (-10%) ≤ Stock return rate < Market return rate (+10%)
Sell	Stock return < - Market return (-10%)

Notes: 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 2005 (HSI total return index 2005-17 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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Office address: ABCI Securities Company Limited, 13/F Fairmont House, 8 Cotton Tree Drive, Central, Hong Kong.

Tel: (852) 2868 2183