



## ZTE (00763 HK/000063 CH)

### Business to recover in 2Q20

- ZTE's 1Q20 business was affected by COVID-19 pandemic but we believe business will recover in 2Q20 on China's 5G network development plan
- CAPEX of the Chinese telecom operators is estimated to be RMB 334.8bn in 2020(+ 11.7% YoY)
- Better product mix with more high-end products would lift ZTE's gross profit margin
- Recommend **BUY** with TP of HK\$ 29.0 for ZTE-H (763 HK), which implies 21.9x/ 16.9x FY20E/ FY21E P/E, and **HOLD** for ZTE-A (000063 CH) with a TP of RMB 40.0, equivalent to 33.5x/ 25.8x FY20E/21E P/E

**We forecast ZTE's revenue to grow by 15.9% in 2020E, driven by 5G network development in China.** The Chinese telecom operators are speeding up 5G network development domestically and ZTE's revenue growth is expected to recover in 2Q20. Based on announcements by the telecom operators, 2020 CAPEX would be RMB 334.8bn (including RMB 180.3 bn for 5G CAPEX).

**Gross profit margin to benefit from 5G products.** Driven by increased contribution from 5G products, ZTE's gross margin is estimated to grow by 1.4ppt/ 1.1ppt/ 0.9ppt to 36.5%/ 37.6%/ 38.5% in 2020E-22E.

**Net profit to grow at a CAGR of 24.7% in 2019-22E.** Due to ZTE's solid growth and margin expansion, ZTE's net profit is estimated to grow by 7.0%/ 29.7% in 2020-21E.

**Valuation.** We recommend (1) **BUY** on **ZTE-H (763 HK)** with the TP of HK\$ 29.0, which implies 21.9x/ 16.9x FY20E/ FY21E P/E; (2) **HOLD** on **ZTE-A (000063 CH)** with TP of RMB 40.0, which is equivalent to 33.5x/ 25.8x FY20E/ FY21E P/E.

#### Results and Valuation

FY ended Dec 31	FY18A	FY19A	FY20E	FY21E	FY22E
Revenue (RMB mn)	85,513	90,737	105,170	114,265	124,207
Chg (% YoY)	(21.4)	6.1	15.9	8.6	8.7
Net profit (RMB mn)	(6,983.7)	5,148	5,507	7,142	9,045
Chg (% YoY)	N/A	N/A	7.0	29.7	26.6
EPS (RMB)	(1.666)	1.218	1.194	1.549	1.961
Chg (% YoY)	N/A	N/A	(1.9)	29.7	26.6
BPS (RMB)	5.461	6.819	7.445	8.993	10.954
Chg (% YoY)	(27.7)	24.9	9.2	20.8	21.8
P/E (x) –H shr	(12.4)	17.2	17.7	13.7	10.8
P/E (x) –A shr	(25.2)	34.4	35.1	27.1	21.4
P/B (x)–H shr	3.8	3.1	2.8	2.4	1.9
P/B (x) –A shr	7.7	6.1	5.6	4.7	3.8
ROAE (%)	(25.6)	19.9	17.4	18.8	19.7
ROAA (%)	(5.1)	3.8	3.4	3.6	3.9

\*Exchange rate assumption for FY20E-22E: HKD 1 = RMB 0.900

Source(s): Bloomberg, ABCI Securities estimates

### Company Report

Rating (H): BUY  
Rating (A): HOLD

TP(H): HK\$ 29.0  
TP(A): RMB 40.0

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Price (H/A shr)	23.50/ 41.92
Est. s price return (H/A shr)	48.9%/ -4.6%
Est. dividend yield (H/A shr)	0.0%/ 0.0%
Est. total return (H/A shr)	48.9%/ -4.6%
Last Rating & TP (H/A shr)	BUY, HK\$31.0 BUY, RMB42.0

Previous Report Date Jan 15, 2020

Source(s): Bloomberg, ABCI Securities estimates

#### Key Data:

52Wk H/L (HK\$) (H shr)	36.70/ 17.72
52Wk H/L (RMB) (A shr)	56.70/ 26.50
Total issued shares (mn)	
Issued H shr (mn)	755.5
Issued A shr (mn)	3,856.5
H-shr market cap (HK\$ mn)	17,754
A-shr market cap (RMB mn)	161,664

#### Major shareholder(s):

Zhongxingxin	27.4%
Central Huijin Asset Management	1.2%
Hunan Nantian	1.0%

Source(s): Company, ABCI Securities estimates



ZTE's 1Q20 net profit came in weaker than expected mainly because of the COVID-19 outbreak during the period. Manufacturing capacity in 1Q20 was affected by shutdowns of production plants and disruptions of the supply chain. 1Q20 revenue and net profit dropped by 3.2% and 9.6%. Net profit declined more sharply than revenue because of higher R&D expenses that accounted for 15.1% of total revenue in 1Q20, up 1.2ppt YoY. The higher R&D expenses are caused by the innovations and development for 5G products. The pandemic has also raised the demand for cloud computing as the use of video conference, online teaching, and online entertainment increased substantially due to social distancing, which further increases the demand for faster and stable 5G network.

#### Exhibit 1: ZTE's 1Q20 financial table

RMB mn	1Q20	1Q19	YoY
Revenue	21,484	22,202	(3.2%)
Net Profit	780	863	(9.6%)
Net profit margin	3.6%	3.9%	(0.3ppt)

Source(s): the Company

We expect ZTE's results to rebound in 2Q20 with the recovery of productions and business activities in the domestic market. To meet their annual 5G target by 3Q20, the Chinese telecom operators are expected to speed up their network development pace. China Telecom (728 HK) will team up with China Unicom (762 HK) to co-build 250,000 5G base stations in 2020.

China market contributed 64% of total revenue for ZTE in FY18 and FY19. China and MIIT have emphasized the need to expedite 5G network development in China. Chinese telecom operators have announced their 2020 CAPEX of RMB 334.8bn (+11.7% YoY) (including RMB 180.3bn for 5G CAPEX), and will develop the 5G standalone network to improve speed and transmission quality. We therefore expect ZTE's revenue growth to ramp up in 2Q20. The Group will also benefit from higher gross profit margin with more demand for 5G equipment.

#### Exhibit 2: Proposed CAPEX of the Chinese telecom operators for 2020

RMB bn	China Mobile	China Unicom	China Telecom
Overall CAPEX	179.8	70.0	85.0
YoY Growth	8.4%	24.1%	9.6%
5G CAPEX	100.0	35.0	45.3
YoY Growth	316.7%	343.0%	388.9%
5G CAPEX to overall CAPEX ratio	55.6%	50.0%	53.3%

Source(s): the Companies

In 2020, ZTE has won the bid to construct the 5G network for 12 provinces in China while securing another contract for a 35% share in the 5G network construction for 31 provinces. Driven by the increasing 5G product contributions, ZTE's gross margin is estimated to grow by 1.4ppt/ 1.1ppt/ 0.9ppt to 36.5%/ 37.6%/ 38.5% in 2020-22E. Nonetheless, we lower our 2020E-21E revenue by 2.4%/ 2.1% due to the impact of COVID-19 and related supply chain disruptions. We also adjust the company's R&D expenses to reflect higher costs for 5G products development. Overall 2020E-21E net profit is lowered by 10.9%/ 7.5%.



### Exhibit 3: Changes in our financial estimates

(RMB mn)	OLD			NEW			CHANGE		
	FY20E	FY21E	FY22E	FY20E	FY21E	FY22E	FY20E	FY21E	FY22E
Revenue	107,799	116,750	N/A	105,170	114,265	124,207	-2.4%	-2.1%	N/A
Operating profit	10,807	12,607	N/A	9,703	11,605	13,873	-10.2%	-7.9%	N/A
Net Profit	6,179	7,719	N/A	5,507	7,142	9,045	-10.9%	-7.5%	N/A

Source(s): Company, ABCI Securities estimates

### Valuations

Our valuations for ZTE-H/A (763 HK/000063 CH) are based on the DCF model (WACC: 13.2%/13.0%; perpetuity growth rate: 2%/2%). We recommend BUY for H shr with TP at HK\$29.0 and HOLD for A shr with TP at RMB 40.0. The H-shr TP implies 21.9x/ 16.9x FY20E/ FY21E P/E for the H-shr, while A-shr TP is equivalent to 33.5x/ 25.8x FY20E/ FY21E P/E.

### Exhibit 4: Peer Comparison

		P/E					P/B				ROE	ROA	EV/EBITDA
	Ticker	Price*	19A	20E	21E	22E	19A	20E	21E	22E	20E	20E	20E
<u>H-share market</u>													
ZTE	763 HK	23.50	16.0	16.6	13.3	11.1	2.9	2.3	2.0	1.7	14.9	4.0	18.3
COMBA	2342 HK	3.17	51.3	23.3	16.3	17.1	2.3	2.0	1.8	1.7	6.1	2.1	n.a.
Xiaomi	1810 HK	10.20	21.3	19.2	15.3	12.1	2.7	2.5	2.1	1.8	14.6	5.7	16.3
Average			29.5	19.7	15.0	13.4	2.6	2.3	2.0	1.7	11.9	3.9	17.3
<u>A-share market</u>													
ZTE	000063 CH	41.92	33.7	34.0	27.0	20.6	6.0	4.3	3.7	3.2	14.5	4.2	17.0
Jiangsu Zhongtian	600522 CH	11.17	17.1	15.1	12.3	n.a.	1.6	1.5	1.3	n.a.	10.3	6.1	n.a.
Hengtong Optic-Electric	600487 CH	16.62	23.1	17.4	14.0	9.9	2.3	2.1	1.9	n.a.	11.7	3.9	12.0
Accelink Technologies Co	002281 CH	29.70	54.0	41.8	33.1	25.5	4.3	4.5	4.1	3.4	10.8	5.4	31.5
Average			32.0	26.5	20.9	18.7	3.6	3.1	2.8	3.3	11.8	4.9	20.2

\*Based on closing price on May 6, 2020

Source(s): Bloomberg



農銀國際

ABC INTERNATIONAL

ABCI SECURITIES COMPANY LIMITED

ZTE (00763 HK / 000063 CH)

China Telecom Sector

May 7, 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.

### **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.

### **Concentration risk**

By region, over 64% of total revenue for ZTE in FY18 and FY19 were driven from China. Any adverse changes in China or telecom carriers business will have adverse impacts on ZTE's probability and valuation.



## Financial Statements

### Consolidated income statement (2018A-2022E)

FY Ended Dec 31 (RMB mn)	2018A	2019A	2020E	2021E	2022E
Carriers' networks	57,076	66,584	79,235	87,159	95,875
Government & Corporate business	9,228	9,155	9,887	10,401	10,942
Consumer business	19,210	14,997	16,047	16,705	17,390
<b>Total revenue</b>	<b>85,513</b>	<b>90,737</b>	<b>105,170</b>	<b>114,265</b>	<b>124,207</b>
Gross profit	26,875	31,859	38,387	42,964	47,820
Other income and gains	4,630	6,816	6,475	6,152	5,844
R&D costs	(10,906)	(12,548)	(15,775)	(16,683)	(18,010)
Selling and distribution expenses	(9,085)	(7,869)	(10,307)	(11,312)	(11,800)
Administrative expenses	(4,106)	(5,289)	(5,606)	(6,055)	(6,539)
Others	(12,954)	(3,414)	(3,471)	(3,461)	(3,442)
<b>Operating Profits</b>	<b>(5,545)</b>	<b>9,555</b>	<b>9,703</b>	<b>11,605</b>	<b>13,873</b>
Finance cost	(1,008)	(1,718)	(1,528)	(1,359)	(1,209)
Share of profits and losses of associates	(797)	(676)	(642)	(610)	(579)
<b>Profit before tax</b>	<b>(7,350)</b>	<b>7,162</b>	<b>7,533</b>	<b>9,636</b>	<b>12,084</b>
Tax	401	(1,385)	(1,379)	(1,763)	(2,211)
<b>Profit after tax</b>	<b>(6,949)</b>	<b>5,777</b>	<b>6,155</b>	<b>7,873</b>	<b>9,873</b>
Minority interests	383	(280)	(299)	(382)	(479)
Perpetual capital instruments	(417)	(349)	(349)	(349)	(349)
<b>Net profit</b>	<b>(6,984)</b>	<b>5,148</b>	<b>5,507</b>	<b>7,142</b>	<b>9,045</b>
<b>EPS (RMB)</b>	<b>(1.666)</b>	<b>1.218</b>	<b>1.194</b>	<b>1.549</b>	<b>1.961</b>

Source(s): Company, ABCI Securities estimates



Consolidated balance sheet (2018A-2022E)

As of Dec 31 (RMB mn)	2018A	2019A	2020E	2021E	2022E
PPE	8,898	9,383	12,199	12,829	13,539
Intangible assets	8,558	7,719	9,888	11,376	12,854
Others	19,047	21,533	31,598	34,820	35,342
<b>Total non-current assets</b>	<b>36,503</b>	<b>38,635</b>	<b>53,685</b>	<b>59,025</b>	<b>61,734</b>
Cash & cash equivalents	24,290	33,309	44,725	66,437	94,213
Inventories	25,011	27,689	29,073	30,527	32,053
Receivables	22,208	20,181	21,396	22,684	24,049
Others	21,339	21,389	34,834	36,071	37,426
<b>Total current assets</b>	<b>92,848</b>	<b>102,567</b>	<b>130,028</b>	<b>155,719</b>	<b>187,741</b>
<b>Total assets</b>	<b>129,351</b>	<b>141,202</b>	<b>183,713</b>	<b>214,744</b>	<b>249,476</b>
Bank borrowings	23,740	26,646	23,981	21,583	19,425
Payables	28,397	28,617	27,267	25,986	24,774
Others	35,979	31,107	72,396	100,318	129,345
<b>Total current liabilities</b>	<b>88,115</b>	<b>86,371</b>	<b>123,644</b>	<b>147,888</b>	<b>173,544</b>
Bank borrowings	2,367	10,045	8,639	7,429	6,389
Others	5,908	6,832	7,133	7,456	7,802
<b>Total non-current liabilities</b>	<b>8,275</b>	<b>16,877</b>	<b>15,772</b>	<b>14,886</b>	<b>14,191</b>
<b>Total liabilities</b>	<b>96,390</b>	<b>103,248</b>	<b>139,416</b>	<b>162,774</b>	<b>187,735</b>
Shareholders' equity	22,898	28,827	34,334	41,476	50,522
Others	10,063	9,127	9,963	10,493	11,219
<b>Total equity</b>	<b>32,961</b>	<b>37,954</b>	<b>44,297</b>	<b>51,970</b>	<b>61,741</b>

Source(s): Company, ABCI Securities estimates



### Consolidated Cash Flow Statement (2018A-2022E)

As of Dec 31 (RMB mn)	2018A	2019A	2020E	2021E	2022E
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>

Source(s): Company, ABCI Securities estimates

### Financial Ratios (2018A-2022E)

As of Dec 31	2018A	2019A	2020E	2021E	2022E
Gross profit margin	31.4%	35.1%	36.5%	37.6%	38.5%
Operating profit margin	(6.5%)	10.5%	9.2%	10.2%	11.2%
Net profit margin	(8.2%)	5.7%	5.2%	6.3%	7.3%
ROAA	(5.1%)	3.8%	3.4%	3.6%	3.9%
ROAE	(25.6%)	19.9%	17.4%	18.8%	19.7%
<b>% of revenue</b>					
R&D costs	12.8%	13.8%	15.0%	14.6%	14.5%
Selling and distribution expenses	10.6%	8.7%	9.8%	9.9%	9.5%
Administrative expenses	4.8%	5.8%	6.0%	6.0%	5.9%
<b>YoY Growth:</b>					
Revenue	(21.4%)	6.1%	15.9%	8.6%	8.7%
Operating profit	N/A	N/A	1.5%	19.6%	19.5%
Net profit	N/A	N/A	7.0%	29.7%	26.6%

Source(s): Company, ABCI Securities estimates



## Disclosures

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I, Lai Pak Kin, Ricky, being the person primarily responsible for the content of this research report, in whole or in part, hereby certify that all of the views expressed in this report accurately reflect my personal view about the subject company or companies and its or their securities. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this report. I and/or my associates do not serve as officer(s) of the listed company (ies) covered in this report.

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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%)

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 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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