

ZTE Corporation (00763 HK/000063 CH)

Weak revenue growth in 2023E

- We forecast ZTE Corporation's ("ZTE" or "the Group") to show weak revenue growth and higher R&D expenses-to-revenue ratio in 2023E
- Affected by weak consumer electronic demand and uncertain economic environment, we estimate 2023E revenue to grow by 0.9% YoY.
- We lower 2023E net profit by 7.6%
- Recommend HOLD with TP of HK\$26.0 for ZTE-H (763 HK), which implies 12.7x/ 12.1x 2023-24E P/E, and HOLD for ZTE-A (000063 CH) with TP of RMB36.0, equivalent to 19.6x/ 18.7x 2023-24E P/E

We lower ZTE's 2023E revenue by 14.8%. ZTE's 1H23 revenue grew by 1.5% YoY due to 12.4% drop in government & corporate business, 5.4% growth in carriers' networks business, and 2.6% drop in consumer business. We forecast uncertain economic environment and weak consumer electronic demand will hamper 2023E revenue.

GPM to improve 6.1ppt YoY to 43.3% in 2023E on higher profitability in carriers' network equipment business. 1H23 gross profit margin improved by 6.2ppt YoY to 43.2% on the 8.9ppt gain in carriers' network equipment GPM.

We lower 2023E net profit forecast by 7.6%. The R&D expenses-to-revenue ratio is expected to rise 3.5ppt YoY to 21.1% in 2023E due to new product innovations and development. Despite a higher GPM, net profit is affected by weak revenue growth and higher R&D-to-revenue ratio.

Valuation. We recommend (1) **HOLD** on **ZTE-H (763 HK)** with TP of HK\$ 26.0, which implies 12.7x/12.1x 2023-24E P/E; (2) **HOLD** on **ZTE-A (000063 CH)** with TP of RMB36.0, equivalent to 19.6x/18.7x 2023-24E P/E.

Risk factors: 1) Slowdown in 5G development; 2) Decreasing ROE; 3) Fierce market competition; 4) Lower 2H23 net profit compared to 1H23.

Results and Valuation

FY ended Dec 31	FY21A	FY22A	FY23E	FY24E	FY25E
Revenue (RMB mn)	114,522	122,954	124,065	132,399	140,100
Chg (% YoY)	12.9	7.4	0.9	6.7	5.8
Net profit (RMB mn)	6,813	8,080	8,783	9,230	10,225
Chg (% YoY)	59.9	18.6	8.7	5.1	10.8
EPS (RMB)	1.467	1.706	1.836	1.930	2.138
Chg (% YoY)	59.6	16.3	7.6	5.1	10.8
BPS (RMB)	10.882	12.382	13.801	15.293	16.946
Chg (% YoY)	16.0	13.8	11.5	10.8	10.8
P/E (x) –H shr	15.4	13.2	12.3	11.7	10.6
P/E (x) –A shr	23.8	20.5	19.0	18.1	16.3
P/B (x)–H shr	2.1	1.8	1.6	1.5	1.3
P/B (x) –A shr	3.2	2.8	2.5	2.3	2.1
ROE (%)	13.7	14.3	13.9	13.1	13.1
ROA (%)	4.3	4.6	4.7	4.7	4.9
DPS (RMB)	0.000	0.400	0.431	0.452	0.501
Dividend Yield (%)–H shr	0.0	1.4	1.5	1.6	1.8
Dividend Yield (%)–A shr	0.0	1.1	1.2	1.3	1.4

*Exchange rate assumption for FY23E-25E: HKD 1 = RMB 0.9

Source(s): Bloomberg, ABCI Securities estimates

Company Report

Aug 25, 2023

Rating (H): HOLD
 Rating (A): HOLD
 TP(H): HK\$ 26.0
 TP(A): RMB 36.0

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Price (H/A shr)	25.10/ 34.95
Est. price return (H/A shr)	3.6%/ 3.0%
Est. dividend yield (H/A shr)	1.5%/ 1.2%
Est. total return (H/A shr)	5.1%/ 4.2%
Last Rating & TP (H/A shr)	BUY, HK\$31.0
	BUY, RMB42.0
Previous Report Date	May 11, 2022

Source(s): Bloomberg, ABCI Securities estimates

Key Data:

52Wk H/L (HK\$) (H shr)	32.30/ 12.80
52Wk H/L (RMB) (A shr)	46.75 / 20.30
Total issued shares (mn)	4,783.2
Issued H shr (mn)	755.5
Issued A shr (mn)	4,027.7
H-shr market cap (HK\$ mn)	18,963
A-shr market cap (RMB mn)	140,768

Major shareholder(s):

Zhongxingxin	21.30%
Central Huijin Asset Management	0.89%
Hunan Nantian	0.88%

Source(s): Company, ABCI Securities

ZTE's revenue grew 1.5% YoY in 1H23

ZTE's 1H23 revenue grew by a mere 1.5% YoY to RMB60.7bn due to 12.4% YoY drop in government & corporate business revenue, 5.4% YoY growth in carriers' networks business revenue, and 2.6% YoY drop in consumer business revenue. GPM improved 6.2ppt YoY to 43.2% on risen margin in carriers' networks business, which went up 8.9ppt YoY to 54.2%; GPM of government and corporate business rose 0.2ppt YoY to 27.5%, while that of consumer business dropped 1.5ppt YoY to 17.8%. Thanks to higher GPM, overall net profit grew 19.9% to RMB5.5bn.

ZTE's 2023E revenue is revised down by 14.8%

Chinese telecom operators have shifted their CAPEX from 5G network development to data centers and cloud computing development in 2023. Telecom operators' overall CAPEX in 1H23 dropped 7.1% YoY due to lower 5G CAPEX enabled by 5G network sharing agreement. Telecom operators will increase CAPEX for data centers while reducing those for 5G network development, which may affect ZTE's business. As such, we lower carriers' networks business revenue forecast by 2.2% for 2023E. Due to the uncertain economic environment, corporate customers may cut back on equipment consumption. Also, considering the slower-than-expected government & corporate business revenue growth in 1H23, we lower the segment revenue forecast by 22.4%. We expect government & corporate business revenue growth to rebound in 2024-25E due to the replacement need for old equipment and digital transformation of corporate customers. Due to weaker consumer electronic products demand, we lower 2023E consumer business revenue estimate by 37.0%. We expect consumer business revenue growth to rebound in 2024-25E due to the recovery of macro economy activities. Hence, the overall revenue is revised down by 14.8% for 2023E.

Exhibit 1: Telecom operators' CAPEX

(RMB bn)	1H23	YoY
China Mobile (941 HK)	81.4	(11.5%)
China Unicom (762 HK)	27.6	(2.8%)
China Telecom (728 HK)	41.6	(0.1%)
Total	150.6	(7.1%)

Source(s): China Mobile, China Telecom and China Unicom

Exhibit 2: ZTE's revenue forecasts by segment

Revenue (RMB bn)	2021A	2022A	2023E	2024E	2025E
Carriers' networks	75.7	80.0	84.0	89.8	95.1
YoY chg	2.3%	5.7%	5.0%	6.8%	5.9%
Government and corporate business	13.1	14.6	12.7	14.3	15.8
YoY chg	16.0%	11.8%	(13.0%)	12.0%	10.9%
Consumer business	25.7	28.3	27.3	28.4	29.2
YoY chg	59.2%	9.9%	(3.5%)	4.0%	3.0%
Total revenue	114.5	123.0	124.1	132.4	140.1
YoY chg	12.9%	7.4%	0.9%	6.7%	5.8%

Source(s): Group, ABCI Securities estimates

We lower 2023E net profit forecast by 7.6%

We revise up ZTE's gross profit margin forecast from 35.4% to 43.3% in 2023E on higher GPM in carriers' networks business. We forecast ZTE's gross profit margins of carriers'

networks to improve from 2023-25E, due to cost optimization, phasing out of lower margin products and economic of scale effect. The R&D expenses-to-revenue ratio is expected to rise 3.5ppt YoY to 21.1% in 2023E due to new product innovations and development. Although GPM improves, weak revenue growth and higher R&D-to-revenue ratio prompt us to revise down net profit by 7.6%. We forecast ZTE's 2H23 net profit to be RMB3,311 mn, much lower than RMB5,472 mn in 1H23.

Exhibit 3: ZTE's GPM analysis

	2021A	2022A	2023E	2024E	2025E
Carrier network equipment	42.5%	46.2%	54.0%	55.2%	56.0%
Government and corporate business	27.1%	25.4%	27.0%	27.4%	28.0%
Consumer business	18.2%	17.8%	17.9%	18.5%	19.0%
Overall GPM	35.2%	37.2%	43.3%	44.3%	45.1%

Source(s): Group, ABCI Securities estimates

Exhibit 4: Changes in our financial estimates

(RMB mn)	OLD			NEW			CHG		
	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E
Revenue	145,66	160,884	N/A	124,065	132,399	140,100	(14.8%)	(17.7%)	N/A
Net profit	9,510	10,827	N/A	8,783	9,230	10,225	(7.6%)	(14.8%)	N/A
EPS (RMB)	2.010	2.288	N/A	1.836	1.930	2.138	(8.7%)	(15.6%)	N/A

Source(s): Group, ABCI Securities estimates

Recommend HOLD for ZTE-A /H (763 HK/000063 CH)

Our valuations for ZTE-H/A (763 HK/000063 CH) are based on the DCF model (WACC: 13.1%/12.4%; perpetuity growth rate: 2%/2%). We recommend **HOLD** for both A/H shr with TP of HK\$26.0/ RMB36.0. H-shr TP implies 12.7x/12.1x 2023E-24E P/E, while A-shr TP represents 19.6x/18.7x 2023E-24E P/E.



Financial Statements

Consolidated income statement (2021A-2025E)

FY Ended Dec 31 (RMB mn)	2021A	2022A	2023E	2024E	2025E
Carriers' networks	75,712	80,041	84,043	89,758	95,053
Government & Corporate business	13,079	14,628	12,726	14,253	15,807
Consumer business	25,731	28,286	27,296	28,388	29,240
Total revenue	114,522	122,954	124,065	132,399	140,100
Gross profit	40,361	45,727	53,705	58,703	63,211
R&D costs	(18,804)	(21,602)	(26,178)	(29,128)	(31,102)
Selling and distribution expenses	(8,733)	(9,173)	(9,429)	(10,195)	(10,928)
Administrative expenses	(5,445)	(5,333)	(5,759)	(6,220)	(6,718)
Finance cost	(963)	(163)	(1,659)	(1,785)	(1,923)
Others	2,083	(703)	(942)	(1,141)	(1,204)
Profit before tax	8,499	8,752	9,739	10,234	11,337
Tax	(1,463)	(960)	(1,068)	(1,123)	(1,244)
Profit after tax	7,036	7,792	8,671	9,112	10,093
Minority interests	(223)	289	113	118	131
Net profit	6,813	8,080	8,783	9,230	10,225
EPS (RMB)	1.467	1.706	1.836	1.930	2.138
DPS (RMB)	0.000	0.400	0.431	0.452	0.501

Source(s): Group, ABCI Securities estimates



Consolidated balance sheet (2021A-2025E)

As of Dec 31 (RMB mn)	2021A	2022A	2023E	2024E	2025E
Fixed assets	11,437	12,913	13,559	14,237	14,949
Intangible assets	8,095	7,342	6,975	6,626	6,295
Others	21,361	22,825	23,519	24,260	25,049
Total non-current assets	40,892	43,080	44,052	45,123	46,292
Cash	50,713	56,346	64,223	72,101	80,938
Inventories	36,317	45,235	47,497	49,872	52,365
Receivables	18,116	18,030	19,115	20,265	21,484
Others	22,725	18,262	16,812	15,606	14,614
Total current assets	127,871	137,874	147,647	157,843	169,401
Total assets	168,763	180,954	191,699	202,966	215,693
Short-term loans	8,947	9,962	10,261	10,569	10,886
Payables	22,934	20,522	19,626	18,780	17,982
Others	46,805	47,939	48,477	49,309	50,433
Total current liabilities	78,685	78,424	78,364	78,658	79,301
Long-term loans	29,908	35,126	38,287	41,733	45,489
Others	6,882	7,861	8,204	8,555	8,935
Total non-current liabilities	36,791	42,987	46,491	50,288	54,424
Total liabilities	115,476	121,410	124,855	128,946	133,726
Total equity attributable to holders of ordinary shares of the parent	51,482	58,641	65,365	72,431	80,259
Non-controlling interests	1,806	902	1,479	1,588	1,709
Total shareholders' equity	53,288	59,543	66,845	74,019	81,967

Source(s): Group, ABCI Securities estimates



Consolidated Cash Flow Statement (2021A-2025E)

As of Dec 31 (RMB mn)	2021A	2022A	2023E	2024E	2025E
Operating profit before change in working capital	120,976	136,875	136,471	145,639	154,110
Change in working capital	(103,146)	(127,814)	(115,638)	(134,402)	(142,289)
Others	(2,106)	(1,483)	(1,737)	(2,016)	(2,323)
Operating cash flow	15,724	7,578	19,096	9,220	9,497
CAPEX	(4,982)	(4,981)	(4,980)	(4,979)	(4,978)
Change in investments	(6,322)	3,547	4,358	5,390	6,414
Others	711	143	(1,066)	(1,528)	(1,825)
Investing cash flow	(10,592)	(1,291)	(1,688)	(1,117)	(389)
Change in borrowings	5,309	5,406	3,460	3,754	4,073
Others	(2,530)	(3,951)	(3,951)	(4,155)	(4,502)
Financing cash flow	2,779	1,455	(491)	(401)	(428)
Effect of changes in foreign exchange rate on cash and cash equivalents	(242)	260	234	176	158
Net increase in cash and cash equivalents	7,668	8,001	17,152	7,877	8,838
Cash and cash equivalents at beginning of year	31,403	39,071	47,072	64,223	72,101
Cash and cash equivalents at end of year	39,071	47,072	64,223	72,101	80,938

Source(s): Group, ABCI Securities estimates

Financial Ratios (2021A-2025E)

As of Dec 31	2021A	2022A	2023E	2024E	2025E
Gross profit margin	35.2%	37.2%	43.3%	44.3%	45.1%
Operating profit margin	7.6%	7.2%	7.9%	7.7%	8.1%
Net profit margin	5.9%	6.6%	7.1%	7.0%	7.3%
ROA	4.3%	4.6%	4.7%	4.7%	4.9%
ROE	13.7%	14.3%	13.9%	13.1%	13.1%
% of revenue					
R&D costs	16.4%	17.6%	21.1%	22.0%	22.2%
Selling and distribution expenses	7.6%	7.5%	7.6%	7.7%	7.8%
Administrative expenses	4.8%	4.3%	4.2%	4.2%	4.2%
YoY Growth:					
Revenue	12.9%	7.4%	0.9%	6.7%	5.8%
Net profit	59.9%	18.6%	8.7%	5.1%	10.8%

Source(s): Group, ABCI Securities estimates

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Rating	Definition
Buy	Stock return rate \geq Market return rate ($\sim 9\%$)
Hold	- Market return rate ($\sim 9\%$) \leq Stock return rate $<$ Market return rate ($\sim 9\%$)
Sell	Stock return $<$ - Market return ($\sim 9\%$)

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 2006 (HSI total return index 2006-22 averaged at 8.4%)

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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