

# China Communications Services Corporation (0552.HK)



Phillip Securities (Hong Kong) Ltd  
Phillip Securities Research

“Buy” Rating for Low Valuation

Bloomberg | Reuters | POEMS

0552.HK | 0552.HK | 0552.HK

Industry: Technology Hardware & Equipment

2014-4-14

## Annual report review

Rating: Buy CP: HK\$3.71 TP: HK\$4.80

### Company Overview

China Communication Services Corporation (CCS) is the leading integrated service supplier in the field of telecommunications, media and technologies. It mainly serves China Telecom, China Mobile, China Unicom and other major clients. The main scope of business covers Telecommunications Infrastructure Services (TIS), Business Process Outsourcing (BPO) services and Application, Content and Other (ACO) services.

### Investment Summary

According to 2013 annual report announced by CCS, its revenue in 2013 reached RMB 68.5 billion with a year-on-year growth of 11.3%, but the net profit fell to 2.238 billion yuan with a year-on-year drop of 7%, of which the net profit in the second half of the year dropped 19.6%, the first performance decline for more than a decade since the listing.

Gross margin of the Company during the period fell by 0.7 percentage points to 15.2% and net profit margin reduced by 0.6 percentage points to 3.3%. Overall speaking, the decline in profitability can be mainly attributed to: firstly, the price pressure resulting from regulatory policies of the telecommunications industry and violent market competition; secondly, the rise of material and subcontracting costs; thirdly, impact from government policies, such as VAT reform; finally, the frontloaded cost for 4G projects preparation, which also affected the profit of the Company.

Although the Company maintained a dividend policy of 40%, namely 0.1296 yuan per share in 2013, the dividend payout ratio will be expected to fall to 30% in 2014, for operators will bear the pressure of 4G capital expenditure with probably a longer payment period and less advance payment under the background of domestic tighter monetary policy.

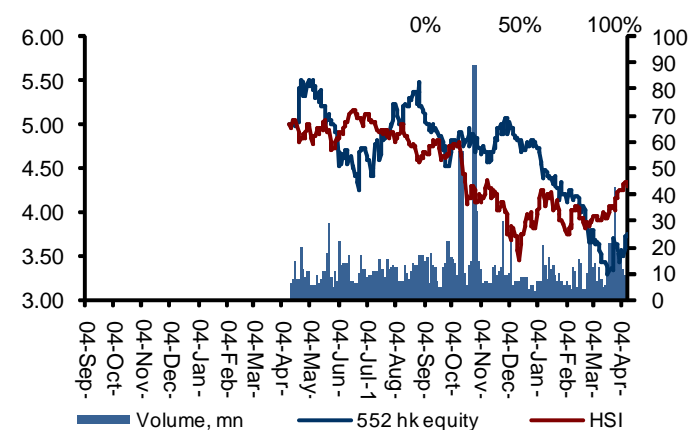
CCS will be expected to benefit from the 4G network construction and the follow-up requirements of relevant support services. Generally speaking, the three major operators contribute two thirds of revenue to the Company. China Mobile has announced that its capital expenditure increases from 184.9 billion yuan in 2013 to 225.2 billion yuan in 2014 with a growth rate of 21.8%. A great part of China Mobile's capital expenditure in the second half of 2013 was delayed to the first half of 2014. For example, its first batch of 207,000 4G base stations were not completed until March 2014 and only 70,000 ones were completed in 2013.

The Company will face the profitability dilemma continuously in view of the following reasons: first, the price pressure from the operators; second, the probability of rise of manpower cost after the completion of population dividend; in addition, R & D cost of the Company in the 4G era will be expected to rise and the cost of expanding overseas business and marketing will also increase.

Considering the business re-expansion progress, we even conservatively give it 9.5X valuation, its target price can reach HKD4.8. We grant it "Buy" rating.

### China Comm Services

|                                    |              |            |
|------------------------------------|--------------|------------|
| <b>Rating</b>                      | <b>1.00</b>  | <b>Buy</b> |
| - Previous Rating                  | 2.00         | Accumulate |
| <b>Target Price (HKD)</b>          | <b>4.8</b>   |            |
| - Previous Target Price (HKD)      | 5.06         |            |
| Closing Price (HKD)                | 3.71         |            |
| Expected Capital Gains (%)         | 29.4%        |            |
| Expected Dividend Yield (%)        | 4.1%         |            |
| <b>Expected Total Return (%)</b>   | <b>33.5%</b> |            |
| Raw Beta (Past 2yrs w weekly data) | 0.55         |            |
| Market Cap. (HKD bn)               | 25,696       |            |
| Enterprise Value (HKD mn)          | 16,877       |            |
| 52 week range (HKD)                | 3.28 - 5.82  |            |
| Closing Price in 52 week range     |              |            |



### Key Financial Summary

| FYE                       | 2012  | 2013  | 2014F | 2015F |
|---------------------------|-------|-------|-------|-------|
| Revenue (RMB mn)          | 61517 | 68459 | 77906 | 84918 |
| Net Profit, adj. (RMB mn) | 2446  | 2238  | 2775  | 3019  |
| EPS, adj. (RMB)           | 0.35  | 0.32  | 0.40  | 0.44  |
| P/E (X),adj.              | 8.3   | 9.2   | 7.3   | 6.7   |
| BVPS (RMB)                | 2.96  | 3.22  | 3.50  | 3.81  |
| P/B (X)                   | 1.0   | 0.9   | 0.8   | 0.8   |
| DPS (RMB)                 | 0.14  | 0.13  | 0.12  | 0.13  |
| Div. Yield (%)            | 4.7%  | 4.4%  | 4.1%  | 4.4%  |

Source: Bloomberg, PSR est.

\*All multiples & yields based on current market price

### Valuation Method

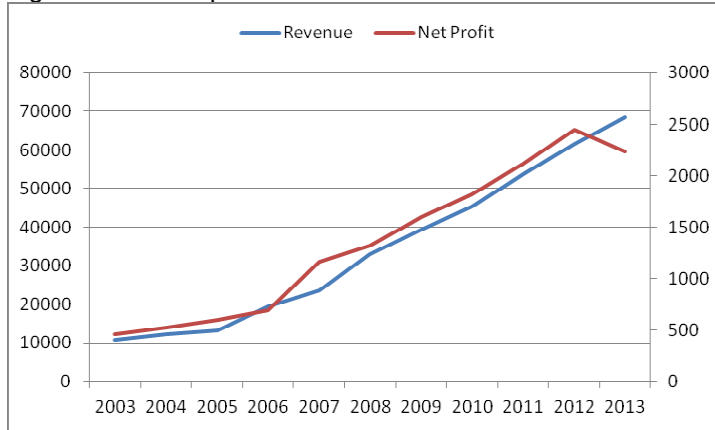
P/E (X)

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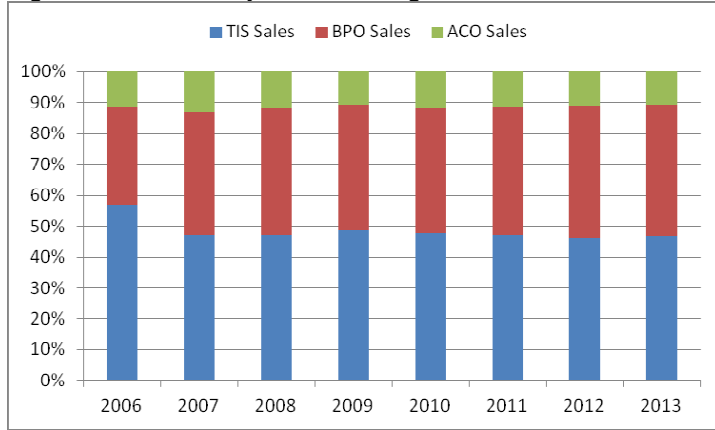
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Figure 1: CCS experienced the first decline in 2013



Sources: Company reports, Phillip Securities

Figure 2: Revenue by business segment



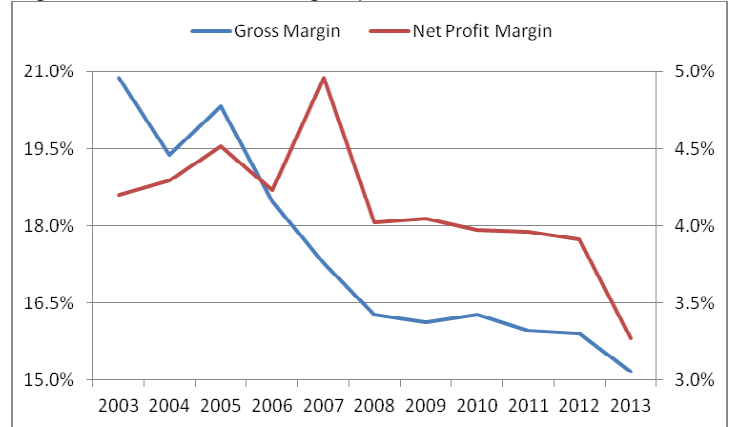
Sources: Company reports, Phillip Securities

Figure 3: COGS breakdown of CCS



Sources: Company reports, Phillip Securities

Figure 4: Declined earning capabilities



Sources: Company reports, Phillip Securities

Figure 5: P/E valuation Band



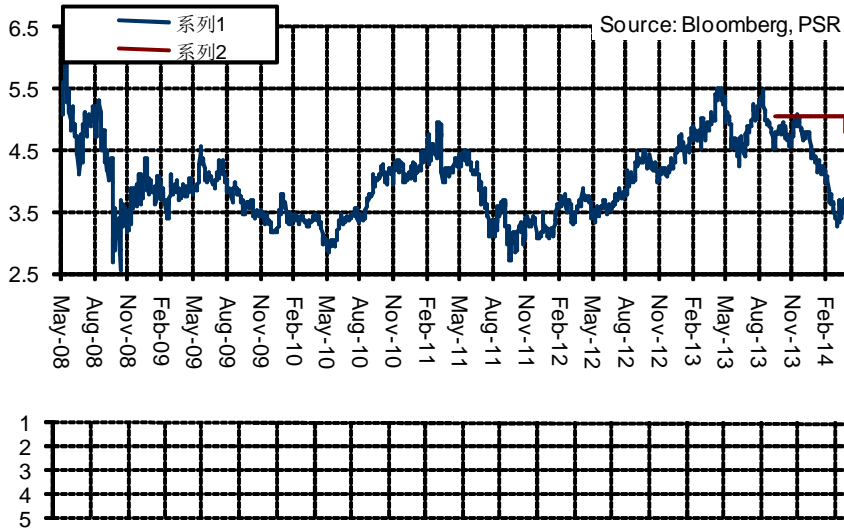
Sources: Bloomberg, Phillip Securities

## Financial Status

| FYE                                 | 2011   | 2012   | 2013   | 2014F  | 2015F  |
|-------------------------------------|--------|--------|--------|--------|--------|
| <b>Valuation Ratios</b>             |        |        |        |        |        |
| Price Earnings                      | 8.19   | 8.30   | 9.16   | 7.33   | 6.66   |
| Price to Book                       | 1.06   | 0.99   | 0.91   | 0.84   | 0.77   |
| Dividend Yield                      | 4.1%   | 4.7%   | 4.4%   | 4.1%   | 4.4%   |
| <b>Per share data(RMB)</b>          |        |        |        |        |        |
| EPS Adjusted                        | 0.36   | 0.35   | 0.32   | 0.40   | 0.44   |
| Book Value Per Share                | 2.76   | 2.96   | 3.22   | 3.50   | 3.81   |
| Dividends Per Share                 | 0.12   | 0.14   | 0.13   | 0.12   | 0.13   |
| <b>Growth &amp; Margin</b>          |        |        |        |        |        |
| Revenue growth                      | 18.4%  | 14.4%  | 11.3%  | 13.8%  | 9.0%   |
| Gross Profit growth                 | 16.1%  | 14.0%  | 6.1%   | 14.5%  | 9.4%   |
| Net Profit growth                   | 16.3%  | 15.7%  | -8.5%  | 24.0%  | 8.8%   |
| Gross Margin                        | 16.0%  | 15.9%  | 15.8%  | 15.3%  | 15.3%  |
| Net Profit Margin                   | 4.0%   | 3.9%   | 3.8%   | 4.0%   | 4.0%   |
| Dividend Payout Ratio %             | 39.7   | 40.0%  | 40.0%  | 30.0%  | 30.0%  |
| <b>Key Ratios</b>                   |        |        |        |        |        |
| Return on Assets                    | 5.8%   | 5.7%   | 4.8%   | 5.4%   | 5.4%   |
| Return on Equity                    | 13.8%  | 13.1%  | 10.3%  | 11.9%  | 11.9%  |
| Tax ratio                           | 20.2%  | 19.3%  | 17.7%  | 18.0%  | 18.0%  |
| Liability ratio                     | 57.3%  | 53.3%  | 53.8%  | 55.0%  | 55.0%  |
| <b>Income Statement(RMB: mn)</b>    |        |        |        |        |        |
| <b>Revenue</b>                      | 53,780 | 61,517 | 68,459 | 77,906 | 84,918 |
| - Cost of Goods Sold                | 45,199 | 51,732 | 58,081 | 66,026 | 71,925 |
| <b>Gross Income</b>                 | 8,581  | 9,785  | 10,378 | 11,881 | 12,992 |
| - Selling, General & Admin Expenses | 6,505  | 7,563  | 8,288  | 9,427  | 10,275 |
| <b>Operating Income</b>             | 2,530  | 2,782  | 2,571  | 3,116  | 3,397  |
| - Interest Expense                  | 65     | 26     | 11     | 18     | 20     |
| <b>Pretax Income</b>                | 2,670  | 3,031  | 2,779  | 3,445  | 3,749  |
| - Income Tax Expense                | 539    | 586    | 493    | 620    | 675    |
| <b>Income Before XO Items</b>       | 2,131  | 2,446  | 2,285  | 2,825  | 3,074  |
| - Minority Interests                | 2      | 39     | 47     | 50     | 55     |
| <b>Net Profit</b>                   | 2,115  | 2,446  | 2,238  | 2,775  | 3,019  |

Source: Company reports, Phillip Securities

**Ratings History**



**PSR Rating System**

| Total Returns | Recommendation | Rating |
|---------------|----------------|--------|
| > +20%        | Buy            | 1      |
| +5% to +20%   | Accumulate     | 2      |
| -5% to +5%    | Neutral        | 3      |
| -5% to -20%   | Reduce         | 4      |
| <-20%         | Sell           | 5      |

**Remarks**

We do not base our recommendations entirely on the above quantitative return bands. We consider qualitative factors like (but not limited to) a stock's risk reward profile, market sentiment, recent rate of share price appreciation, presence or absence of stock price catalysts, and speculative undertones surrounding the stock, before making our final recommendation

#### PHILLIP RESEARCH STOCK SELECTION SYSTEMS

| Total Return | Recommendation | Rating | Remarks                                      |
|--------------|----------------|--------|--|
| >+20%        | Buy            | 1      | >20% upside from the current price           |
| +5% to +20%  | Accumulate     | 2      | +5% to +20% upside from the current price    |
| -5% to +5%   | Neutral        | 3      | Trade within $\pm$ 5% from the current price |
| -5% to -20%  | Reduce         | 4      | -5% to -20% downside from the current price  |
| <-20%        | Sell           | 5      | >20% downside from the current price         |

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