

# ZTE Corporation(0763.HK)

4G Business Contribution will Increase Significantly  
Bloomberg | Reuters | POEMS  
0763.HK | 0763.HK | 0763.HK  
Industry: Technology Hardware & Equipment



Phillip Securities (Hong Kong) Ltd  
Phillip Securities Research

23 April 2014

## Annual report review

Rating: Buy CP: HK\$16.58 TP: HK\$20.25

### Company Overview

ZTE is the world-leading provider of telecom solutions, providing technical and product solutions for telecom operators and intranet users in 160 countries and regions. Its main products include carriers' network, terminals, telecommunication software systems and service, etc.

### Investment Overview

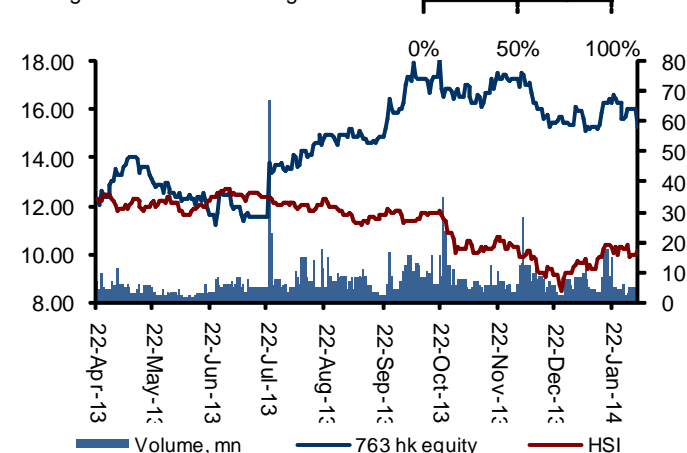
Due to the periodic trough of investments in domestic communication equipment and quarterly decreased overseas telecommunication operators' investments caused by the global economic downturn, ZTE has experienced decline in performance of two years. However, the financial report of 2013 published recently indicates that though the revenue drops 10.6% yoy to 75.2 billion RMB, the net profit rises 148% and reaches 1.36 billion RMB, converting into earnings per share of 0.39 RMB, which means that the company's performance shows signs of recovery. This mainly profits from 5 percentage points increase of gross profit margin which is 27.2% now. And among that, the gross profit margin of carriers' network business substantially rises over 10 percentage points to 37.4%.

The company's performance in 1Q14 continued to recover. Its revenue reach 19.053 billion RMB with a growth of 5.51%, and net profit attributable to shareholders reach 622 million RMB, with the growth of 203.51%. This mainly benefits from the confirmation of incomes of 4G primary devices with high earning capability, the development of overseas business and the decrease of financial costs due to the depreciation of the RMB. In addition, the company also forecasts that the performance in the first half year of 2014 will increase by 158% to 223% to 0.8 to 1 billion RMB.

After the preliminary construction of 4G network is completed and covers large and medium-sized cities in Mainland China, smart cellphones may experience changing phones trend. In the first quarter, 4G cellphones only accounted for 4.1% among all cellphones of domestic brands, which was far lower than that of international brands, namely 20.6%. However, domestic 4G cellphones will be released in succession starting from the second quarter. And domestic 4G smart cellphones of one thousand RMB will have great impact on international brands relying on their high cost-effective performance. Therefore, the prospect of smart cellphone industry in the mainland is still optimistic. With the technological advantages of ZTE, the realization of the company's terminal goal, namely increasing the shipment of smart cellphones from 40 million in 2013 to 60 million and realizing the growth of income of smart cellphones for 20% on year-on-year basis, is a large probability event after the product line and distribution channels finish recombination.

### ZTE Corp

Rating	1.00	Buy
- Previous Rating	1.00	Buy
Target Price (HKD)	20.25	
- Previous Target Price (HKD)	21.84	
Closing Price (HKD)	16.58	
Expected Capital Gains (%)	22.1%	
Expected Dividend Yield (%)	0.9%	
Expected Total Return (%)	23.0%	
Raw Beta (Past 2yrs weekly data)	1.13	
Market Cap. (HKD bn)	58,182	
Enterprise Value (HKD mn)	65,664	
52 week range (HKD)	10.84 - 18.34	
Closing Price in 52 week range		



### Key Financial Summary

FYE	2011	2012	2013	2014F
Revenue (RMB mn)	86254	84219	75233	91032
Net Profit, adj. (RMB mn)	2060	-2841	1358	2765
EPS, adj. (RMB)	0.61	-0.83	0.39	0.80
P/E (X),adj.	21.7	-	33.9	16.4
BVPS (RMB)	7.04	6.25	6.55	7.03
P/B (X)	1.9	2.1	2.0	1.9
DPS (RMB)	0.20	0.00	0.03	0.20
Div. Yield (%)	1.5%	0.0%	0.2%	1.5%

Source: Bloomberg, PSR est.

\*All multiples & yields based on current market price

### Valuation Method

P/E (X)

### Phillip Research

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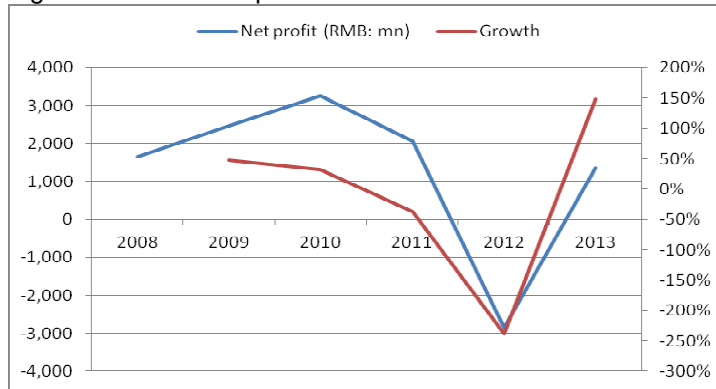
+8621 51699400

As the core supplier of primary devices, ZTE is expected to obviously benefit from the arrival of 4G investment period. The capital expenditure of China Mobile in 2014 is 225 billion RMB with a year-on-year growth of 22%. China Unicom and China Telecom also are probable to have additional investment in wireless business after obtaining the 4G business licenses of FDD-LTE. It is also worth mentioning that the carriers' network business is highly profitable, and the increase of its contribution in 2014 also means that the gross profit margin of the company is probable to keep rising in succession.

After the "Prism" event, departments of domestic governments and enterprises gradually show the trend of de-Cisco, which is a good opportunity of development for ZTE, Huawei, Ruijie and other domestic manufacturers with the addition of the government's construction planning of safe and intelligent cities. After ZTE increases the resource investment, it is expected that this business is probable to become the third growth pole following primary device and terminal in the middle period, and its revenue proportion is probable to rise to twenty or thirty percent from the current ten percent.

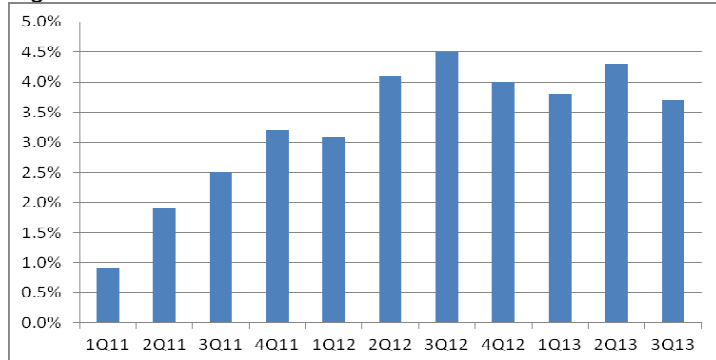
Viewing from the historical valuation, the company's valuation once reached 37 times during the peak period of 3G capital expenditures in 2009, and the average PE ratio also has reached 22 to 23 times in the downturn period since 2011. Even we assume that the PE ratio valuation is 20 times that of EPS in 2014, the target price can reach 20.25 HKD, which is "Buy" rating.

Figure 1: Recovered performance



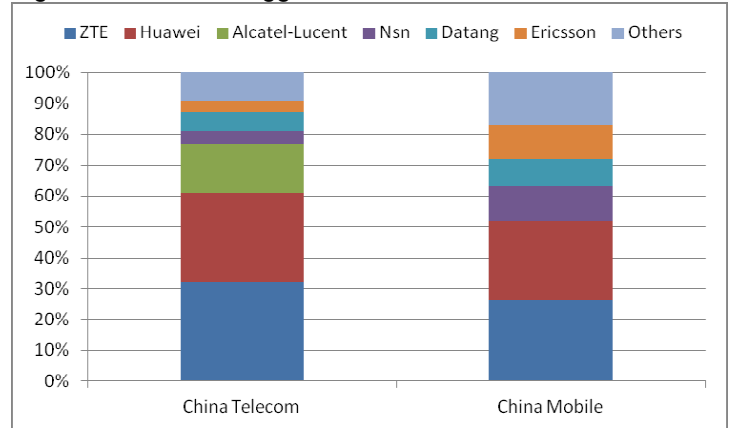
Sources: Company reports, Phillip Securities

Figure 2: Market share of ZTE terminal



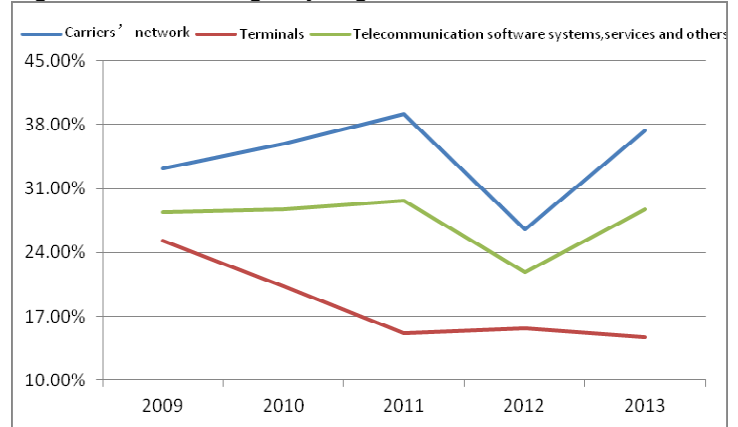
Sources: Gartner, Phillip Securities

Figure 3: ZTE wins biggest share in LTE tenders



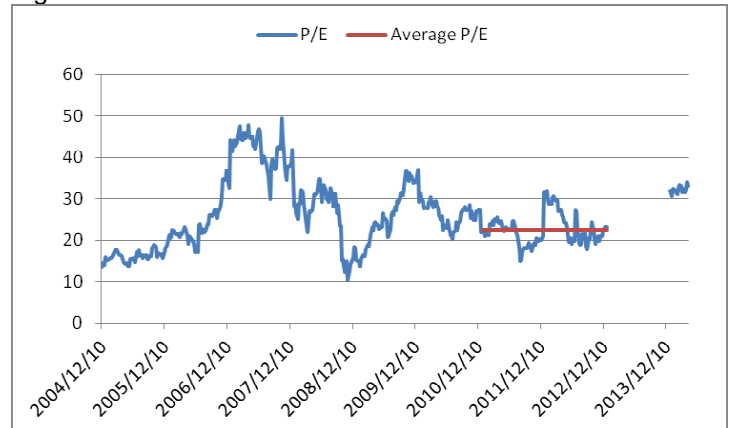
Sources: Phillip Securities

Figure 4: Gross margin by segments



Sources: Company reports, Phillip Securities

Figure 5: P/E valuation of ZTE

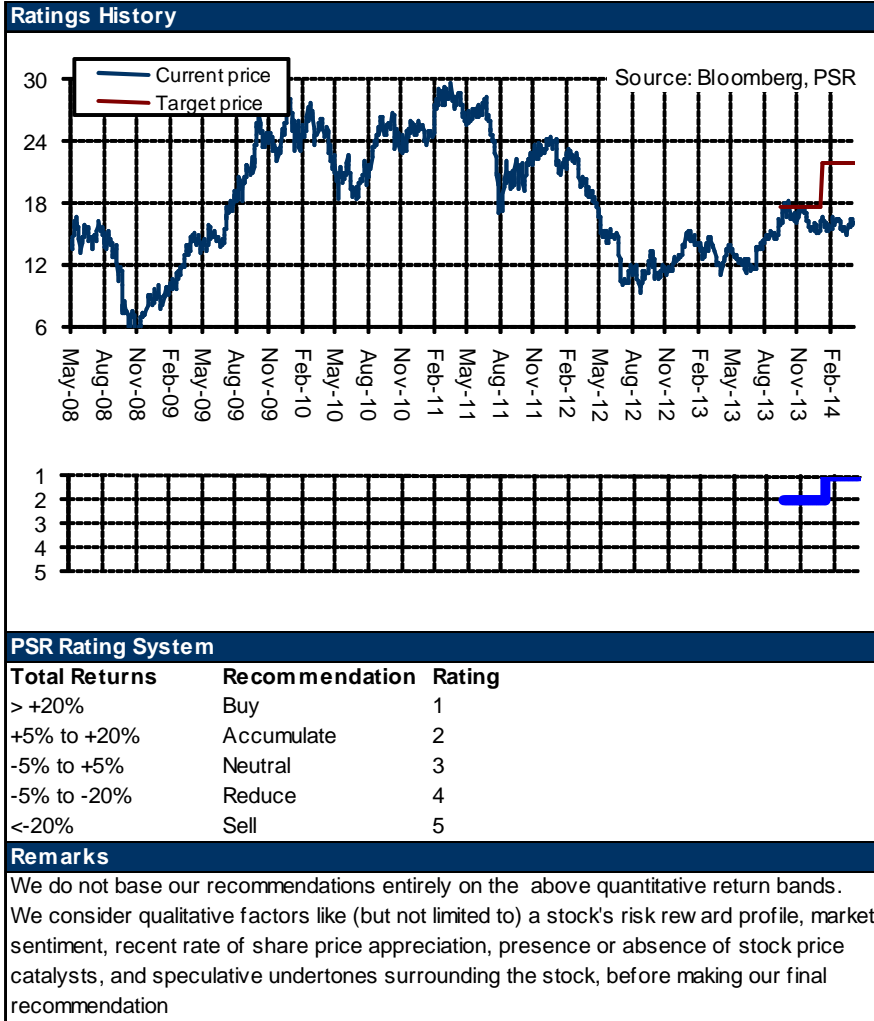


Sources: Bloomberg, Phillip Securities

## Financial Status

FYE	2011	2012	2013	2014F	2015F
<b>Valuation Ratios</b>					
Price Earnings	21.7x	-	33.9x	16.4x	14.0x
Price to Book	1.9x	2.1x	2.0x	1.9x	1.7x
Dividend Yield	1.5%	0.0%	0.2%	1.5%	1.8%
<b>Per share data(RMB)</b>					
EPS Adjusted	0.61	(0.83)	0.39	0.80	0.94
Book Value Per Share	7.04	6.25	6.55	7.03	7.78
Dividends Per Share	0.20	0.00	0.03	0.20	0.24
<b>Growth&amp; Margin</b>					
Revenue growth	23.4%	-2.4%	-10.7%	21.0%	14.6%
Gross Profit growth	11.6%	-22.7%	9.6%	22.4%	15.0%
Net Profit growth	-36.6%	-237.9%	147.8%	103.6%	17.4%
<b>Profitability Ratios</b>					
Gross Margin	30.3%	23.9%	27.2%	27.5%	27.6%
Net Profit Margin	2.4%	-3.4%	1.8%	3.0%	3.1%
Dividend Payout Ratio %	33.3%	0.0%	7.6%	25.0%	25.0%
<b>Key Ratios</b>					
Return on Assets	2.1%	-2.6%	1.3%	2.6%	2.9%
Return on Equity	8.7%	-12.4%	5.9%	11.5%	12.6%
Effective Tax Rate	14.9%	-31.3%	21.6%	20.5%	20.5%
Liability ratio	75.6%	79.4%	76.9%	77.4%	76.7%
<b>Income Statement(RMB: mn)</b>					
<b>Revenue</b>	<b>86,254</b>	<b>84,219</b>	<b>75,233</b>	<b>91,032</b>	<b>104,347</b>
- Cost of Goods Sold	62,086	65,545	54,775	65,998	75,547
<b>Gross Income</b>	<b>24,168</b>	<b>18,674</b>	<b>20,458</b>	<b>25,034</b>	<b>28,800</b>
- Selling, General & Admin Expenses	23,786	23,042	19,802	24,123	27,339
<b>Operating Income</b>	<b>2,751</b>	<b>-1,162</b>	<b>2,857</b>	<b>3,960</b>	<b>4,661</b>
- Interest Expense	852	1,165	1,045	1,331	1,438
- Foreign Exchange Losses (Gains)	837	136	865	-100	-100
- Net Non-Operating Losses (Gains)	-1,574	-480	-880	-950	-980
<b>Pretax Income</b>	<b>2,635</b>	<b>-1,983</b>	<b>1,828</b>	<b>3,679</b>	<b>4,303</b>
- Income Tax Expense	392	621	394	754	882
<b>Income Before XO Items</b>	<b>2,243</b>	<b>-2,605</b>	<b>1,434</b>	<b>2,925</b>	<b>3,421</b>
- Minority Interests	183	236	76	160	175
<b>Net Profit</b>	<b>2,060</b>	<b>-2,841</b>	<b>1,358</b>	<b>2,765</b>	<b>3,246</b>

Source: Company reports, Phillip Securities



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

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

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