

21 July 2014
**China Communication Service Co.,
 LTD. (0552.HK)**

4G motive power may accelerate

HONG KONG | TMT | EVENT REVIEW

The three major operators announce that they will fund 10 billion yuan to establish China Communication Facilities Service Limited Company (IE "Tower Company"). Tower Company clearly states that it will favor China's Communication Service Co., Ltd. (CCS) under equal conditions when it publicly outsources its design, construction, supervision and maintenance of the tower and its related supporting facilities on prerequisite that it does not lead to the breach of the Non-competition Treaty between China Telecom and CCS. If stock assets registration happens, the agent maintenance agreement signed by initiators of Tower Company and CCS will still be effective. When the contract expires, it will carry out outsourcing, and still favor CCS under equal conditions.

On the whole, the operation of Tower Company this time is only limited to tower rather than basic station, the investment of which only accounts for 5% of the operator's CAPEX. Therefore, the adverse effect of it on communication industry in terms of capital spending is smaller than market expected previously. Besides, the company has no non-governmental capital, and CCS further gains priority. Therefore, the cooperation framework between CCS and the three major operators is not affected. The turnover of the company of general contribution of 3 major operators is over 63%. It is worth mentioning that currently the continuous development of mainland mobile virtual network operation will benefit from the reform process from a mid-term and long-term perspective. It will benefit the non-operator business of CCS. In 2013, in this field the company grows 16.1%, above the 9% growth rate of operators.

The market effect of 4G has already appeared. We believe that it will promote the investment of China Telecom and China Unicom in 4G. By the end of June, the two companies have gained FDD-LTE. Currently, China Telecom has opened 4G business in 16 cities. It is reported that in 2013 China Telecom has invested about 13.2 billion yuan in the construction of 4G on accumulative basis. In 2014, the investment is expected to exceed 40 billion yuan. In next 2 to 3 years, the investment will continue to increase with larger scale, exceeding hundred billion yuan. It is worth mentioning that the market share of CCS reaches 80%. Therefore, we believe the 4G business contribution in the last half year is expected to accelerate. The company's TIS department will be the major beneficiary of LTE investment upswing period.

The profitability of the company is continuously weak. Gross margin decreased from 20.9% of 2003 to 15.2% of 2013. Net profit margin decreased from 5% of 2007 to 3.3%. We expect that the profitability difficulty the company face will continue. Except for price pressure of operators and the cost upswing of human resources after the end of demographic dividend, the set-up of Tower Company will also weaken the price negotiating right and further bring pressure to profit margin.

Investment Action

4G investment upswing cycle will promote the acceleration of company's domestic business. Meanwhile the impact of Tower Company's upcoming establishment is lower than market expectation. We expect that turnovers of 2014 and 2015 will be 78.1 billion yuan and 87.7 billion yuan respectively. Net profit will be 2.598 billion yuan and 2.896 billion yuan, a year-on-year growth of 16.1% and 11.5%, and the EPS will be 0.38 yuan and 0.42 yuan.

The company has maintained steady growth after listing and we make valuation by referring to price-to-earnings ratio. By looking back the history of the company, as the profitability falls off, the central price-to-earnings ratio also falls from 10.6X of 2010-2011 to 9.4X since 2012. However, considering the 4G motive power may accelerate, we grant it 10 times of the EPS valuation of 2014, and the 12-m target price is HK\$4.7. We maintain it "Buy" rating.

Key Financial Summary

FYE	12/12	12/13	12/14F	12/15F
Revenue (RMB mn)	61,517	68,459	78,056	87,690
Net Profit, adj. (RMB mn)	2,446	2,238	2,598	2,896
EPS, adj. (RMB)	0.35	0.32	0.38	0.42
P/E (X),adj.	8.7	9.6	8.1	7.4
BVPS (RMB)	2.96	3.22	3.48	3.79
P/B (X)	1.04	0.95	0.88	0.81
DPS (RMB)	0.14	0.13	0.11	0.13
Div. Yield (%)	4.5%	4.2%	3.6%	4.2%

Source: Bloomberg, PSR est.

*All multiples & yields based on current market price

Rating:

Buy

Maintain at Buy

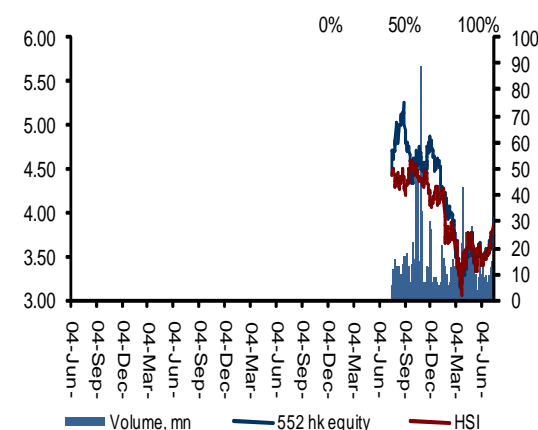
Target Price (HKD)	4.70
Forecast Dividend (RMB)	0.11
Closing Price (HKD)	3.87
Potential Upside	25.0%

Company Description

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.

Company Data

Raw Beta (Past 2yrs weekly data)	0.56
Market Cap. (HKD mn)	26,804
Enterprise Value (HKD mn)	15,963
52 week range (HKD)	3.28 - 5.49
Closing Price in 52 week range	



Major Shareholders

1.China Telecom	51.40%
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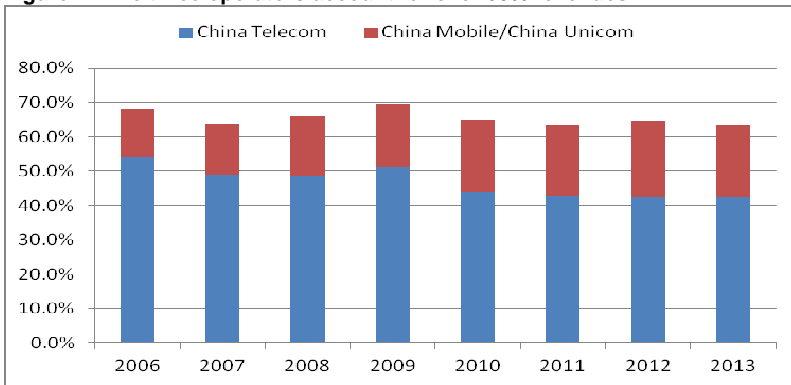
Valuation Method

PE

Research Department

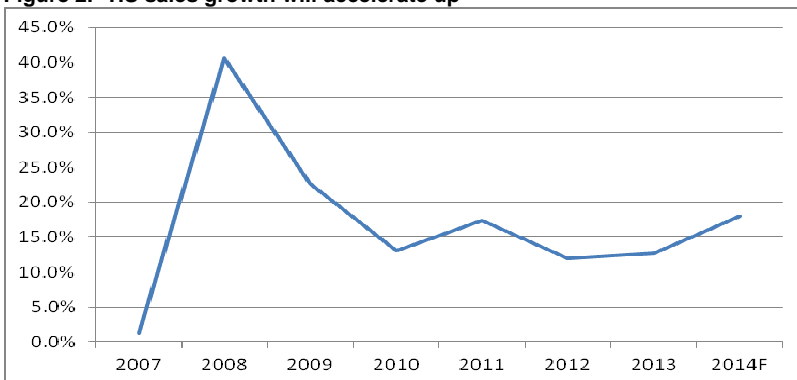
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Figure 1. The three operators account for over 60% revenues



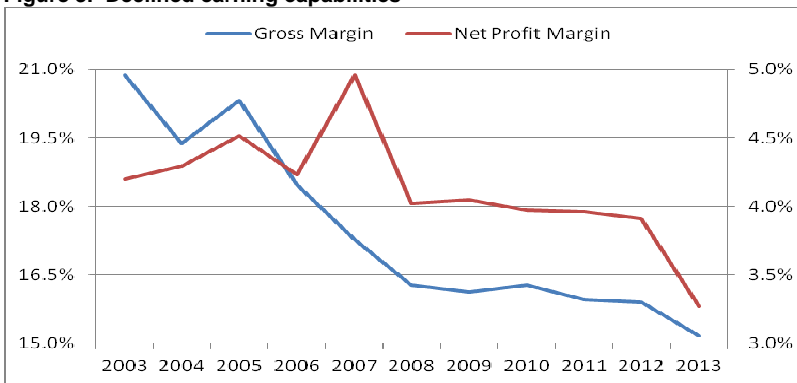
Source: Company reports, PSR

Figure 2. TIS sales growth will accelerate up



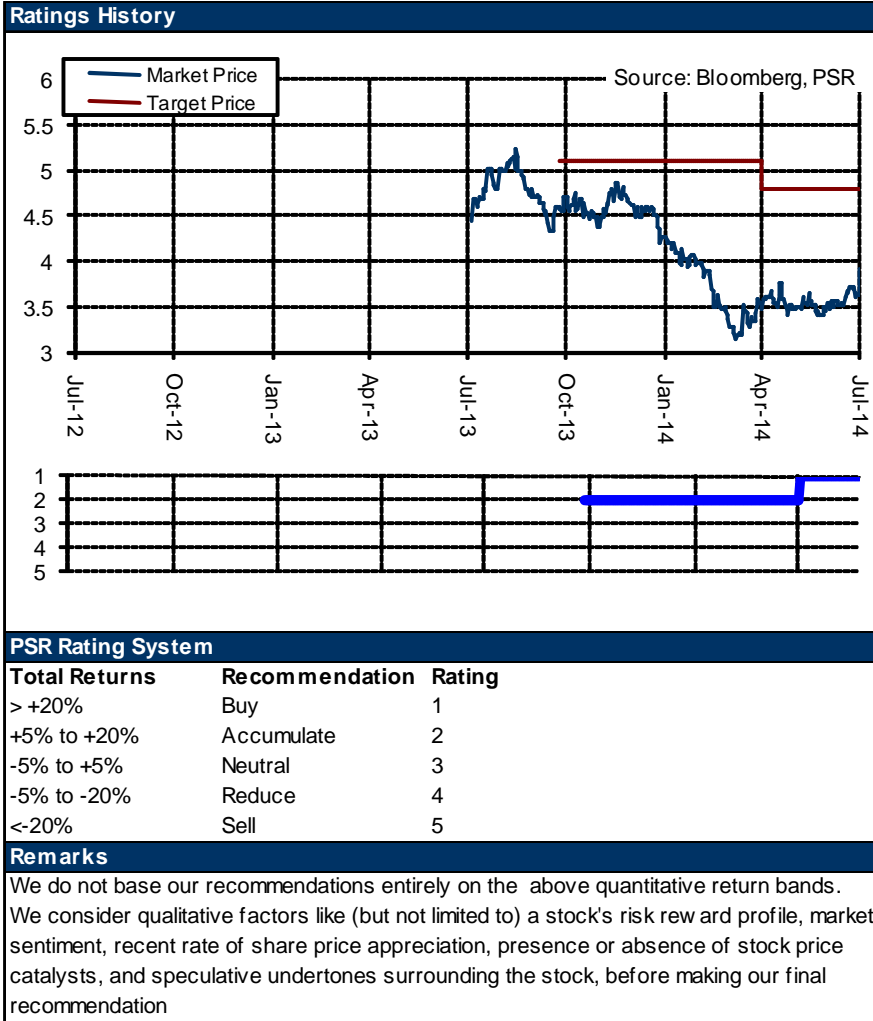
Source: Company reports, PSR

Figure 3. Declined earning capabilities



Source: Company reports, PSR

FYE	2011	2012	2013	2014F	2015F
Valuation Ratios					
Price Earnings	8.58	8.70	9.60	8.08	7.31
Price to Book	1.11	1.04	0.95	0.88	0.81
Dividend Yield	3.9%	4.5%	4.2%	3.6%	4.2%
Per share data(RMB)					
EPS Adjusted	0.36	0.35	0.32	0.38	0.42
Book Value Per Share	2.76	2.96	3.22	3.48	3.79
Dividends Per Share	0.12	0.14	0.13	0.11	0.13
Growth & Margin					
Revenue growth	18.4%	14.4%	11.3%	14.0%	12.3%
Gross Profit growth	16.1%	14.0%	6.1%	14.2%	12.1%
Net Profit growth	16.3%	15.7%	-8.5%	16.1%	11.5%
Gross Margin	16.0%	15.9%	15.2%	15.2%	15.2%
Net Profit Margin	4.0%	3.9%	3.3%	3.3%	3.3%
Dividend Payout Ratio %	39.7	40.0%	40.0%	30.0%	30.0%
Key Ratios					
Return on Assets	5.8%	5.7%	4.8%	5.1%	5.2%
Return on Equity	13.8%	13.1%	10.3%	11.2%	11.5%
Tax ratio	20.2%	19.3%	17.7%	17.8%	17.8%
Liability ratio	57.3%	53.3%	53.8%	55.0%	55.0%
Income Statement(RMB: mn)					
Revenue	53,780	61,517	68,459	78,056	87,690
- Cost of Goods Sold	45,199	51,732	58,081	66,207	74,405
Gross Income	8,581	9,785	10,378	11,849	13,285
- Selling, General & Admin Expenses	6,505	7,563	8,288	9,523	10,698
Operating Income	2,530	2,782	2,571	2,943	3,288
- Interest Expense	65	26	11	18	20
Pretax Income	2,670	3,031	2,779	3,222	3,590
- Income Tax Expense	539	586	493	573	639
Income Before XO Items	2,131	2,446	2,285	2,648	2,951
- Minority Interests	2	39	47	50	55
Net Profit	2,115	2,446	2,238	2,598	2,896



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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