PhillipCapital

China Communications Services (552.HK)

TIS business will still keep growing fast

Hong Kong | TMT| Company report

26 November 2015

Benefitted from the construction of 4G network and speed enhancement of optical fiber broadband by the domestic telecommunication operators, the revenue from telecommunications infrastructure service of China Communications services (CCS) in 1H15 surged 16.6% to RMB 18 billion, the total revenue increased by 11.3% to RMB 37.6 billion. Being adversely affected by the increase of labor cost, the Company`s gross profit margin dropped by 0.5 ppts to 13.8%. It is mainly due to the significant increase of subcontracting cost as 21.4%, which marked as the highest level since the same period in 2012. Therefore, net profit attributable to shareholders in 1H15 only increased slightly by 2.7% to RMB 1.27 billion, with basic EPS recorded as RMB 0.184.

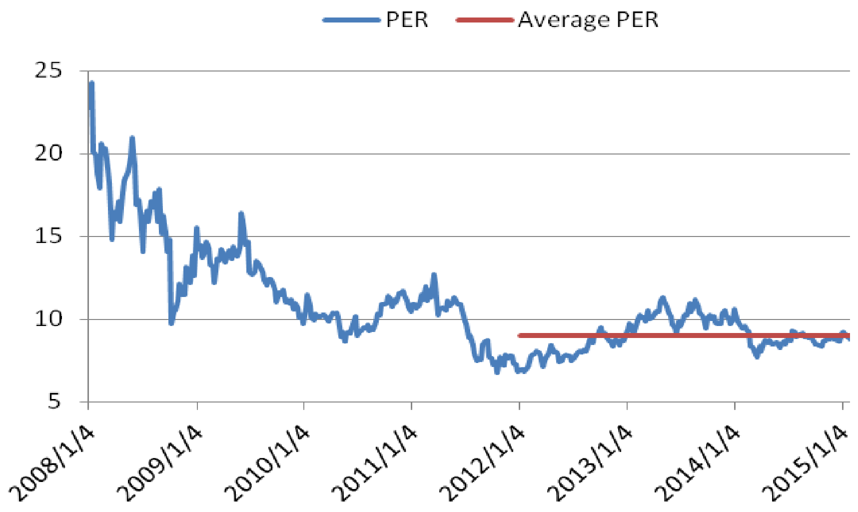
As a fundamental industry supporting economic restructuring, we believe the IT industry would continually receive policy support and the Company would also be benefitted. The former Chairman of China Telecom, Wang Xiaochu, was transferred to China Unicom. This may help the Company to gain more orders from China Unicom. Moreover, China Tower has basically completed the acquisition of telecommunication tower assets from the top three telecommunication operators. It may bring new opportunities for CCS`s business development. Meanwhile, the overseas market would become one of the growth momentums in the future.

We expect improvement in the upcoming future: Firstly, the rate of increase of subcontracting charge has been too high in recent years. Such pressure may be eased with the release of bonus to domestic engineers. Secondly, through strict cost control, the overall growth of other cost items of the Company is mild, which effectively offset the pressure from the increase of subcontracting charge. Moreover, the Company continued to strengthen the management of operating capital, the cash flow of operating activities in 1H15 recorded a positive figure, which is the first time in the first half year since listing. The financial condition of the Company is getting healthier, so the financial costs may decrease.

Growth prospect still expectable, with valuation under-estimated

China will speed up construct communication networks, the overseas business may also become growth momentum gradually for CCS. In addition, persistent decline of profitability is unlikely and thus we consider the Company will keep steady growth. The Company`s range of P/E ratios has gradually dropped from 10.6x in 2010-2011 to 9x since 2012. We set the 12-month target price as HKD 4.18, based on the valuation corresponding to 10x 2015e EPS, and maintain the rating of "Buy". (Closing price as at 24 Nov 2015)

Historical Valuation



Source: Bloomberg, Phillip Securities (HK) Research

Buy (Maintain)

CMP: HKD 3.12

(Closing price as at 24 Nov 2015)

TARGET: HKD 4.18 (+34%)

COMPANY DATA

O/S SHARES (MN) :	6,926
MARKET CAP (HKDMN) :	21,609
52 - WK HI/LO (HKD):	4.69/ 2.69

SHARE HOLDING PATTERN， %

China Telecom Group.	51.39
China Mobile Group:	8.78

PRICE PERFORMANCE， %

	1M	3M	1Y
CCS	-5.83	4.07	-18.57
HSI	-3.73	-2.59	-13.43

PRICE VS. HSI

Source: Phillip Securities (HK) Research

KEY FINANCIALS

CNY mn	FY13	FY14	FY15E	FY16E
Net Sales	68459	73176	80376	88815
Net Profit	2238	2150	2375	2592
EPS, CNY	0.32	0.31	0.34	0.37
PER, x	7.99	8.25	7.46	6.83
BVPS, CNY	3.22	3.40	3.65	3.92
P/BV, x	0.79	0.75	0.70	0.65
ROE, %	10.3	9.4	9.7	9.9
Debt/Equity (%)	116.45	124.10	129.89	129.89

Source: Company reports, Phillip Securities Est.

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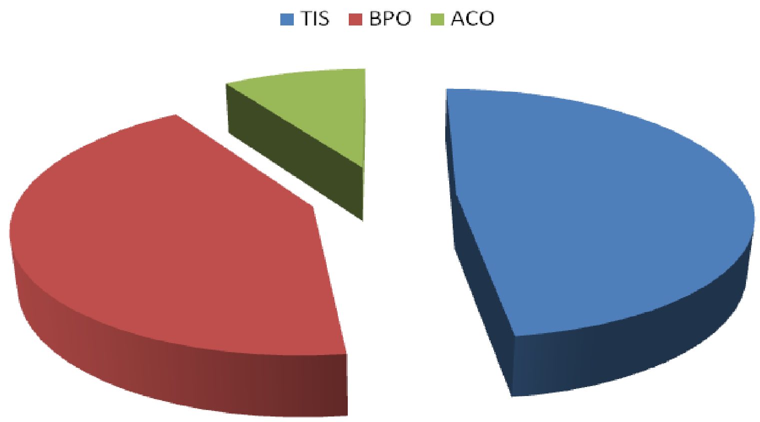
High subcontracting charges affected performance growth

Benefitted from the construction of 4G network and speed enhancement of optical fiber broadband by the domestic telecommunication operators, the revenue from telecommunications infrastructure service of CCS in 1H15 surged 16.6% to RMB 18 billion. However, the revenue from business process outsourcing services only grew by 7.6% to RMB 16.1 billion; while the income from a variety of other services including applications, content and others even merely grew by 3.3% yoy to RMB 3.5 billion. In sum, the Company`s total revenue only increased by 11.3% to RMB 37.6 billion, which was slightly lower than our expectation.

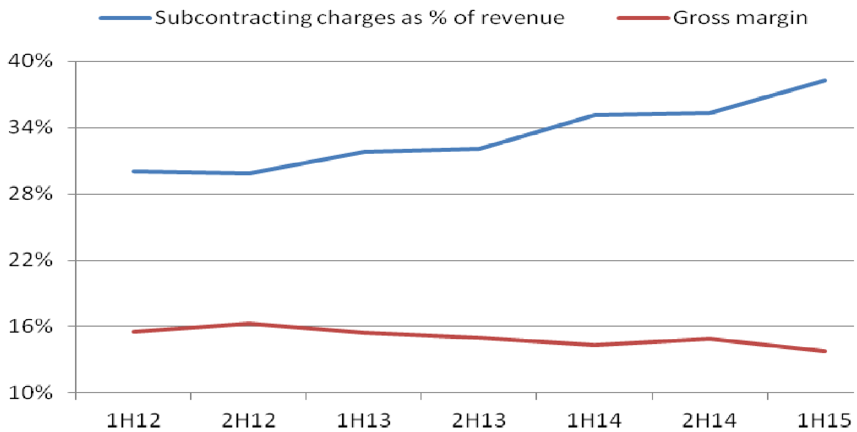
Revenue by segments in 1H15



Source: Phillip Securities (HK) Research

What`s more, being adversely affected by the increase of labor cost, the Company`s gross profit margin dropped by 0.5 ppts to 13.8%. It is mainly due to the significant increase of subcontracting cost as 21.4%, which marked as the highest level since the same period in 2012. The proportion of subcontracting cost in total revenue also moved up 3.2 ppts, from 35.1% in the same period last year increased to 38.3%. Such figure is far higher than that recorded in 2012 which was approximately 30%. Therefore, net profit attributable to shareholders in 1H15 only increased slightly by 2.7% to RMB 1.27 billion, with basic EPS recorded as RMB 0.184.

Declining profitability with surged subcontracting charges



Source: Phillip Securities (HK) Research

TIS business will still keep growing fast

As a fundamental industry supporting economic restructuring, we believe the IT industry would continually receive policy support and the Company would also be benefitted. Recently, NDRC pointed out the need to speed up the nurturing of strategical newly-emerged industries so as to shape them as key driving forces of economic development, and to create a new generation of five emerging pillar industries of "ten trillion class", covering information technology, high-end equipment and materials, digital innovations etc. Specifically, in medium-/short- term, after the issuance of FDD license, China Telecom and China Unicom will also speed up the construction of 4G network. It is worth to note that the former Chairman of China Telecom, Wang Xiaochu, was transferred to China Unicom. This may help the Company to gain more orders from China Unicom. Moreover, China Tower has basically completed the acquisition of telecommunication tower assets from the top three telecommunication operators. It may bring new opportunities for CCS`s business development. Previously, the Company has signed cooperation agreement with the ten provincial-level subsidiaries of China Tower.

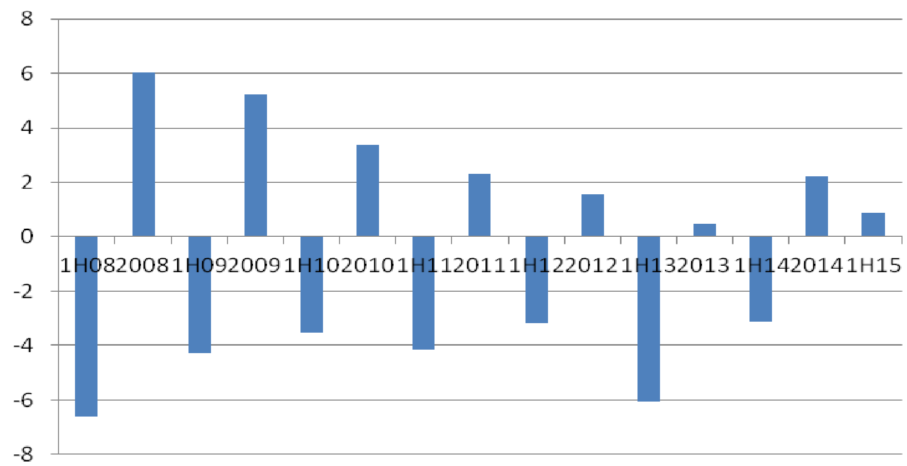
It is also worth to point out that overseas market would become one of the growth momentums in the future. The Chinese Government supports the overseas development of advantageous industries including high-speed rail, nuclear power, aviation and telecommunications, to satisfy the market demand overseas. Particularly in markets with relatively backward telecommunication infrastructure, for example South-east Asia, South America, Middle East and Africa etc, the market demand is huge. CCS has comparative advantages in telecommunications infrastructure, and it is expected to be benefitted from the policies including "One Belt and One Road". However, revenue from overseas in 1H15 decreased 9.2% yoy, with its proportion in total revenue dropped from 5.2% recorded in the same period last year to 4.2%. It is expected to resume to the level of approximately 5%, and further increase to more than 10% in long term.

Persistent decline of profitability unlikely

Being adversely affected by the pressures from the increase of outsourcing low-end business and labor cost, the Company`s profitability in recent years declined continually. However, we expect improvement in the upcoming future: Firstly, the rate of increase of subcontracting charge has been too high in recent years. Such pressure may be eased with the release of bonus to domestic engineers. Secondly, through strict cost control, the overall growth of other cost items of the Company is mild, which effectively offset the pressure from the increase of subcontracting charge. Since 2012, even though the proportion of subcontracting cost to revenue increased by more than 8 ppts, the proportion of total cost to revenue merely increased about 2 ppts. The Company`s decrease of EBIT profit margin also dropped from the previous 0.5 ppts to the current 0.2 ppts.

Moreover, the Company continued to strengthen the management of operating capital, changing the previous trend of uprising. Cash flow of operating activities in 1H15 recorded a positive figure, which is the first time in the first half year since listing. The financial condition of the Company is getting healthier, so the financial costs may decrease.

CCS`s CFFO turn positive for the first time in the first half since listing



Source: Bloomberg, Phillip Securities (HK) Research

Catalyst

4G projects are released faster than expected;
Development of overseas projects beats expectation.

Risks

Profitability continues to decline significantly;
Political and exchange rate risks of overseas projects.

Financials

FYE	2012	2013	2014	2015F	2016F
Valuation Ratios					
Price Earnings	7.24	7.99	8.25	7.46	6.83
Price to Book	0.86	0.79	0.75	0.70	0.65
Dividend Yield	5.4%	5.1%	3.5%	3.9%	4.3%
Per share data(RMB)					
EPS Adjusted	0.35	0.32	0.31	0.34	0.37
Book Value Per Share	2.96	3.22	3.40	3.65	3.92
Dividends Per Share	0.14	0.13	0.09	0.10	0.11
Growth& Margin					
Revenue growth	14.4%	11.3%	6.9%	9.8%	10.5%
Gross Profit growth	14.0%	6.1%	2.9%	6.1%	8.1%
Net Profit growth	15.7%	-8.5%	-3.9%	10.5%	9.1%
Gross Margin	15.9%	15.2%	14.6%	14.1%	13.8%
Net Profit Margin	3.9%	3.3%	2.9%	3.0%	2.9%
Dividend Payout Ratio %	40.0%	40.0%	29.0%	29.2%	29.4
Key Ratios					
Return on Assets	5.7%	4.8%	4.3%	4.3%	4.3%
Return on Equity	13.1%	10.3%	9.4%	9.7%	9.9%
Tax ratio	19.3%	17.7%	17.6%	17.7%	17.7%
Liability ratio	53.3%	53.8%	55.4%	56.5%	56.5%
Income Statement(RMB: mn)					
Revenue	61,517	68,459	73,176	80,376	88,815
- Cost of Goods Sold	51,732	58,081	62,495	69,043	76,559
Gross Income	9,785	10,378	10,682	11,333	12,257
- Selling, General & Admin Expe	7,563	8,288	8,835	9,324	10,081
Operating Income	2,782	2,571	2,419	2,655	2,876
- Interest Expense	26	11	20	45	40
Pretax Income	3,031	2,779	2,631	2,910	3,176
- Income Tax Expense	586	493	463	515	562
Income Before XO Items	2,446	2,285	2,168	2,395	2,614
- Minority Interests	39	47	18	20	22
Net Profit	2,446	2,238	2,150	2,375	2,592

Source: Company, Phillip Securities (HK) Research Estimates

(Financial figures as at 24 November 2015)

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 ± 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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