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Market Insights

Potential Surprises from HK Mobile Operators

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When talking about telecom investing, 9 out of 10 people must tell you to go for the big PRC names such as China Mobile (941), China Unicom (762) and China Telecom (728), or the equipment makers such as ZTE (763). Despite rosy growth prospects, the industry is subject to keen competitions and heavy handset subsidy costs for market share expansion. Nevertheless, Quam sees something interesting for the appeared-to-be boring HK telecom sector, those mobile operators who are launching I-phone 4 plans could have hidden values.

Investors may only invest in 3 listed companies involving mobile operations, namely the Hutchison Telecom HK (HTHK; 215), SmarTone (315) and debt-laden PCCW (8). Worth to note, average revenue per user (ARPU) decline is a long-term trend for the global telecom industry, since telecom companies have been facing technological switch and industry liberalization (i.e. resulted in keener price competitions) over time.

Mid-term Catalysts for HK Mobile Operators

Nevertheless, we see mid-term opportunities for those HK mobile operators in 2011 due mainly to the following catalysts:

- Potential launch of **i-phone 4** businesses may boost the ARPUs for the coming 1 to 2 years
- **Pooling of mobile networks** (e.g. sharing of 4G resources between HTHK and PCCW) may raise efficiency of the mobile operators, thus one-off profit margin increase
- **Increasing usage of data-services** (i.e. mobile internet, PDA) may boost mid-term ARPU

Company Buyback or Shareholder's Buying from SmarTone (315) and HTHK (215)

Besides, we also see recent management repurchase for SmarTone and major shareholder stake increase for Hutchison Telecom HK over the months. Li Ka Shing (through Hutchison and other entities) has been buying the shares of HTHK from HK\$1.30 to HK\$2.20 each between the period of 11 November, 2009 and 2 September, 2010. Holding 3,562.8M shares, **Li Ka Shing currently holds 74.0% in HTHK (69.02% at the beginning of 2010).**

Meanwhile, SmarTone's management has kept buying back shares in 2010, and the purchase prices ranged from HK\$6.90 to HK\$10.48 each.

While most listed companies from various sectors are selling shares through placement, rights-issues or IPO offerings on positive equity market sentiment, HK Mobile Telecom is an exception that **total share supply to the public has been decreasing in 2010.**

Should you believe in the insider theory, the managements and the major shareholders might know something more than you or I do, and they just support their views by share purchase.

The table below lists the operating figures, earnings and valuations of the listed mobile operators:

Listed Telecom Operators with Mobile Business

Company	PCCW (8)	HTHK (215)	SmarTone (315) @
Share Price (HK\$)	3.03	2.40	11.06
09 Revenue (HK\$M)	20,855	8,449	3,957
09 Mobile Revenue (HK\$M)	1,670	4,772	3,452
Mobile to Total (%)	8.01%	56.48%	87.23%
09 Net Profit (HK\$M)	1,506	468	294
10 Net Profit (HK\$M) E #	1,595	643	320
O/S Shares (M)	7,104.3	4,814.6	525.7
10 EPS (HK\$) E #	0.224	0.134	0.609
10 DPS (HK\$) E #	0.146	0.099	0.520
10 P/E	13.50	17.97	18.17
10 Yield (%)	4.80%	4.13%	4.70%

Consensus Estimates

@ SmarTone's financial year ended in June (i.e. FY10 and FY11)

SmarTone and HTHK appear to be Beneficiaries

Amongst the 3 listed telecom operators, PCCW has the least involvement in mobile business and may not benefit a lot from the aforementioned catalysts. **What we are interested in should be HTHK and SmarTone, which have forward yields of around 4.0% to 5.0%.**

Such rich yield appears to be sufficient under a current low interest environment and potential company earnings surprise in 2011. Nevertheless, one should note that the HK mobile investment theme may only hold for mid-term (around 1 year), and their earnings may peak no later than 2012.

Currently, we have **ACCUMULATE & HIGH RISK rating for SmarTone** but **no rating for HTHK**. Despite a forward yield of 4.80%, we maintain the **HOLD & HIGH RISK rating for PCCW** due to the following factors:

- Low mobile revenue contribution of 8.0%
- PCCW may cut dividend payment if the company opts to repay debts
- PCCW placed 500M new shares at HK\$2.60 each in 24 Aug, 2010 to repay debts

Kind Reminder from HKMA Chief

After ex-HKMA chief Mr. Joseph Yam mentioned about the risks of the financial markets couple of weeks ago, present Chief Mr. Norman Chan also expressed his concerns on financial markets and economies yesterday. In his presentation to Legco, Chan included the following issues:

- Global economy is extremely abnormal and this could never last for a prolonged periods
- Low US interest rate is likely to inflate a local property bubble.
- Any risk aversion caused by unforeseen crises could led to interest rate hike, thus raising the burden of mortgage payers
- The recovery of the Western economies has been weakening.
- Excess capital has flooded emerging markets including Hong Kong

Quam also agrees with some of Norman Chan's points, and we have also discovered the abnormal low risk premium demanded for emerging market government bonds. For example, the recent issuance of the Mexico 100-year bond at a low interest yield of 5.794% p.a. also signals the **abnormally high risk tolerance or excess capital flow to the emerging markets**. Any reversal of the fund flow triggered by unexpected events would trigger financial market volatilities.

Similar to what Quam is thinking, the US and EU economies have sign of slowdown in 2011 due to sluggish commercial property market and declining of loan balance (i.e. **de-leveraging**). The chief of TSMC, the largest contract chip manufacturer in the world, recently mentioned of slower 4Q10 sales on weakening consumer electronic product demand. Worth to note, **the chip maker still expects growth in communication related products**, which may benefit from i-phone and PDA product growth.

Although Norman Chan's reminder may not come to reality (no one likes bad things, right?), it is often right to **include some high yield non-cyclical stocks in the portfolios of prudent investors.** Examples could be HK Electric (6), Link REIT (823) and water supplier Guangdong Investment (270). Maybe you could find the local mobile operators such as SmarTone (315) and HTHK (215) to be risky and boring, but they could be interesting alternative choices at this moment.

Currently, we have **ACCUMULATE & LOW RISK** rating for **Link REIT and HK Electric** and **ACCUMULATE & MEDIUM RISK** rating for **Guangdong Investment.** Quam will issue a research on Link REIT (823) soon, and one should not miss it.

Notes on Rating

- Accumulate: The share is undervalued and investors may accumulate on weakness to secure more unrealized value. However, if investors already own excessive holdings of this stock, then they might have to reduce their holdings. Despite having the same rating of "accumulate", some stocks might have higher unrealized value than others.
- Hold: The share is priced close to its value. If investors own excessive holdings of this stock, then they might have to reduce their holdings. Despite having the same rating of "hold", some stocks might have higher unrealized value than others.
- Reduce: The share is not attractively priced and investors should reduce their exposures
- Low risk: Earnings predictability is high. Investors may own relatively high exposures of the share.
- Medium risk: There is a certain degree of earnings predictability. Investors may own controlled exposures of the share. However, if investors own excessive holdings of this stock, then they might have to reduce their holdings.
- High risk: Earnings predictability is low. Exposure should be strictly controlled. If investors own excessive holdings of this stock, then they should reduce their holdings.

Disclosure: Chan Hing, Angus (AVO463), the author of this document declares that as of the date of the publication of this report, he does not hold an interest in the stocks mentioned in the article.