

DBS Group Research . Equity

30 Mar 2022

BUY

Last Traded Price (30 Mar 2022): HK\$3.89 (HSI : 22,232)
Price Target 12-mth: HK\$4.64 (19% upside) (Prev HK\$4.90)

Analyst

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What's New

- FY21 net profit grew 2.5% y-o-y, below market expectations
- Domestic non-operator market expanded 15.9% y-o-y, accounting for 42.9% of total revenue
- Expect gross margin to stabilise and gradually rebound
- Maintain BUY for an attractive dividend yield of c.6% despite a lower TP of HK\$4.64

Price Relative



Forecasts and Valuation

FY Dec (RMBm)	2020A	2021A	2022F	2023F
Turnover	122,649	133,991	146,962	158,367
EBITDA	4,611	4,814	5,151	5,442
Pre-tax Profit	3,488	3,578	3,797	4,083
Net Profit	3,081	3,157	3,349	3,600
Net Profit Gth (Pre-ex) (%)	1.1	2.5	6.1	7.5
EPS (RMB)	0.44	0.46	0.48	0.52
EPS (HK\$)	0.55	0.56	0.59	0.64
EPS Gth (%)	1.1	2.5	6.1	7.5
Diluted EPS (HK\$)	0.55	0.56	0.59	0.64
DPS (HK\$)	0.20	0.21	0.23	0.24
BV Per Share (HK\$)	6.52	6.82	7.20	7.62
PE (X)	7.1	6.9	6.5	6.1
P/Cash Flow (X)	4.0	4.9	3.9	3.7
P/Free CF (X)	11.3	7.6	5.7	5.4
EV/EBITDA (X)	0.0	0.1	0.0	nm
Net Div Yield (%)	5.1	5.5	5.8	6.2
P/Book Value (X)	0.6	0.6	0.5	0.5
Net Debt/Equity (X)	CASH	CASH	CASH	CASH
ROAE (%)	8.6	8.4	8.5	8.6
Earnings Rev (%)			(6)	(2)
Consensus EPS (RMB)			0.54	0.60
Other Broker Recs:		B:11	S:0	H:1

Source of all data on this page: Company, DBS Bank (Hong Kong) Limited ("DBS HK"), Thomson Reuters

Reforms to unlock value

Investment Thesis

SOE reforms by way of introducing strategic shareholders and financial targets in the employee incentive scheme, could be a potential catalyst.

Attractive dividend yield with moderate growth. The stock is trading at c.2SD below its historical average and offers an attractive dividend yield of c.6% with an earnings CAGR of c.7% for FY21-FY23.

Upside from a higher dividend payout ratio is supported by the Rmb22bn net cash position.

Valuation:

The stock is trading at a 7x FY22 PE, c.2SD below its historical average, with an attractive dividend yield of c.6%. Our TP of HK\$4.64 is based on an 8x FY22 PE (unchanged), or 1SD below the historical average.

Where we differ:

Potential unlocking of net cash. We believe SOE reforms will increase the likelihood of unlocking Rmb22bn net cash in hand, representing c.100% of total market cap. We see a possibility of a special dividend or higher dividend payout ratio and expect the market to start pricing this in.

Key Risks to Our View:

Capex cuts by telecom operators. Declines in the capex of telecom operators, due to network investments levelling off or regulatory changes, will impact CCS's earnings outlook.

CT/CU merger. A CT/CU merger may lead to lower total telecom investment for the industry, which could result in increased uncertainty for CCS's business outlook.

At A Glance

Issued Capital - H shares (m shs)	2,391
- Non H shrs (m shs)	4,535
H shs as a % of Total	35
Total Mkt Cap (HK\$/US\$m)	26,942 / 3,442
Major H Shareholders (As % of H shares)	
Federated Hermes International	9.8
H Shares-Free Float (%)	90.2
3m Avg. Daily Val. (US\$m)	3.90
GICS Industry: Information Technology / Software & Services	



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China Communications Services

WHAT'S NEW

FY21 earnings below market expectations; expect gross margin to stabilise and gradually rebound

FY21 results highlights

Revenue increased by 9.2% y-o-y to Rmb134bn in FY21, driven by 15.9% y-o-y growth in the domestic non-operator market, with revenue contribution expanding 2.5ppts to 42.9%. By business segment, telecommunications infrastructure ("TIS") services, business process outsourcing ("BPO") and applications, and content and others (ACO) grew by 7%, 9%, and 18% y-o-y, respectively.

Gross profit increased by 7.6% in FY21 to Rmb14.8bn with gross margin slightly contracting 0.2ppt to 11%.

Net profit increased by 2.5% y-o-y to Rmb3.2bn in FY21, below market expectations. Net profit decreased by 10% in 2H21 due to slower revenue growth and a lower operating margin. The board has proposed a final dividend of Rmb0.1641 per share and a special dividend of Rmb0.0091 per share, totaling Rmb0.1732 per share for FY21 (FY20: Rmb0.1602), representing a final dividend payout ratio of 36% (FY20: 30%).

Outlook

The domestic telecom operator market could benefit from the higher capex and opex from the domestic operators in FY22. The total capex budget for FY22 of the three domestic operators increased by 4% y-o-y to Rmb353bn. The total number of 5G base station net additions is 600k, which is similar to that of FY21. Apart from the construction of the 5G network, domestic operators also targeted to build more data centre cabinets under the national policy of transferring computing resources from east to west ("东数西算"). We expect the domestic non-operator market to remain the key growth driver. The company has secured new contracts worth more than Rmb76.3bn from domestic non-operator customers in

FY21, an increase of more than 10%, mainly pertaining to informatisation infrastructure construction, new infrastructure (data centre), and smart parks.

The company has conducted more rigorous screening for high-gross margin projects in FY21. With the increasing proportion of high-value business and better cost control, the gross margin has been stable at 11.4% in 2H21, the same as in 2H20. We expect the overall gross margin to stabilise and gradually rebound. According to the Share Appreciation Rights Incentive Scheme proposed in Nov 2021, the company targeted to achieve an ROE of at least 8.25%, 8.4% and 8.65% for FY22, FY23 and FY24 respectively.

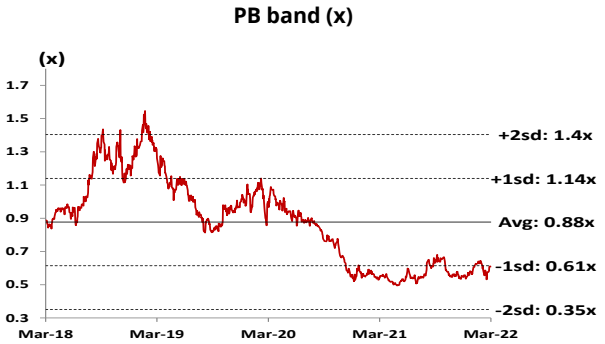
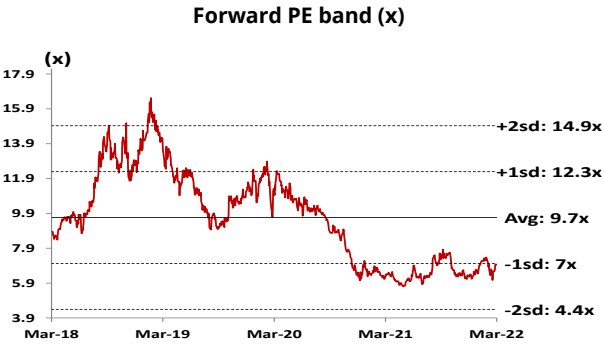
We cut our earnings forecast by 6% and 2% for FY22 and FY23, respectively, mainly due to a lower revenue assumption of TIS business. We forecast earnings to grow by 6.1% and 7.5% for FY22 and FY23, respectively. The stock is trading at a c.7x FY22PE, c.2SD below its historical average. With an attractive dividend yield of c.6% and moderate earnings growth rates, we maintain BUY on CCS with a TP of HK\$4.64. Our TP is based on an 8x FY22 PE (unchanged), 1SD below the historical average.

Company Background

China Communications Services (CCS) is a leading telecom infrastructure service provider in China, with services covering design, construction, and project supervision for telecom networks and support systems. It is also engaged in business process outsourcing and information technology (IT) application services. CCS was 49%-owned by China Telecom Group after the 2.4% share transfer to State Grid ITT Group.

China Communications Services

Historical PE and PB band



Source: Thomson Reuters, DBS HK

China Communications Services

Key Assumptions

FY Dec	2019A	2020A	2021A	2022F	2023F
Domestic operator rev gth %	3.9	(3.4)	5.5	6.0	5.0
Domestic non-operator rev gth %	25.2	18.8	15.9	14.8	11.3
Gross Margin %	11.7	11.2	11.0	11.1	11.1

Source: Company, DBS HK

Segmental Breakdown (RMB m)

FY Dec	2019A	2020A	2021A	2022F	2023F
Revenues (RMB m)					
TIS	64,689	67,165	71,889	79,141	85,489
BPO	36,637	37,277	40,624	43,918	46,746
ACO	16,087	18,207	21,478	23,902	26,132
Total	117,413	122,649	133,991	146,962	158,367

Source: Company, DBS HK

Income Statement (RMB m)

FY Dec	2019A	2020A	2021A	2022F	2023F
Revenue	117,413	122,649	133,991	146,962	158,367
Cost of Goods Sold	(103,726)	(108,911)	(119,207)	(130,701)	(140,797)
Gross Profit	13,687	13,738	14,784	16,261	17,570
Other Opng (Exp)/Inc	(10,518)	(10,646)	(11,592)	(12,824)	(13,871)
Operating Profit	3,169	3,092	3,193	3,437	3,699
Other Non Opg (Exp)/Inc	0	0	0	0	0
Associates & JV Inc	148	169	92	92	92
Net Interest (Exp)/Inc	176	227	294	268	292
Dividend Income	0	0	0	0	0
Exceptional Gain/(Loss)	0	0	0	0	0
Pre-tax Profit	3,494	3,488	3,578	3,797	4,083
Tax	(464)	(398)	(393)	(418)	(449)
Minority Interest	19	(8)	(28)	(30)	(32)
Preference Dividend	0	0	0	(1)	(2)
Net Profit	3,049	3,081	3,157	3,349	3,600
Net Profit before Except.	3,049	3,081	3,157	3,349	3,600
EBITDA	4,569	4,611	4,814	5,151	5,442
Growth					
Revenue Gth (%)	10.6	4.5	9.2	9.7	7.8
EBITDA Gth (%)	11.3	0.9	4.4	7.0	5.6
Opg Profit Gth (%)	0.2	(2.4)	3.3	7.6	7.6
Net Profit Gth (%)	5.1	1.1	2.5	6.1	7.5
Margins & Ratio					
Gross Margins (%)	11.7	11.2	11.0	11.1	11.1
Opg Profit Margin (%)	2.7	2.5	2.4	2.3	2.3
Net Profit Margin (%)	2.6	2.5	2.4	2.3	2.3
ROAE (%)	9.1	8.6	8.4	8.5	8.6
ROA (%)	3.6	3.4	3.2	3.3	3.4
ROCE (%)	7.6	7.1	6.9	7.0	7.2
Div Payout Ratio (%)	36.0	36.0	38.0	38.0	38.0
Net Interest Cover (x)	NM	NM	NM	NM	NM

Source: Company, DBS HK

China Communications Services

Interim Income Statement (RMB m)

FY Dec	2H2019	1H2020	2H2020	1H2021	2H2021
Revenue	61,364	53,834	68,815	64,099	69,892
Cost of Goods Sold	(53,977)	0	(108,911)	0	(119,207)
Gross Profit	7,387	53,834	(40,097)	64,099	(49,315)
Other Oper. (Exp)/Inc	(6,055)	(4,239)	(6,407)	(4,884)	(6,708)
Operating Profit	1,331	49,595	(46,504)	59,216	(56,023)
Other Non Opg (Exp)/Inc	0	0	0	0	0
Associates & JV Inc	81	62	106	34	58
Net Interest (Exp)/Inc	109	101	126	130	163
Exceptional Gain/(Loss)	0	0	0	0	0
Pre-tax Profit	1,521	49,759	(46,271)	59,380	(55,802)
Tax	(193)	(239)	(159)	(292)	(101)
Minority Interest	9	(1)	(7)	(11)	(17)
Net Profit	1,338	49,519	(46,438)	59,078	(55,920)
Net profit bef Except.	1,338	49,519	(46,438)	59,078	(55,920)

Growth

Revenue Gth (%)	10.8	(4.0)	12.1	19.1	1.6
Opg Profit Gth (%)	(2.0)	2,599.5	(3,592.7)	19.4	20.5
Net Profit Gth (%)	2.4	2,793.2	N/A	19.3	(20.4)

Margins

Gross Margins (%)	12.0	100.0	(58.3)	100.0	(70.6)
Opg Profit Margins (%)	2.2	92.1	(67.6)	92.4	(80.2)
Net Profit Margins (%)	2.2	92.0	(67.5)	92.2	(80.0)

Source: Company, DBS HK

China Communications Services

Balance Sheet (RMB m)

FY Dec	2019A	2020A	2021A	2022F	2023F
Net Fixed Assets	4,652	7,799	6,789	8,221	8,502
Invt in Associates & JVs	418	1,351	1,286	1,377	1,469
Other LT Assets	9,219	9,076	12,677	12,487	12,298
Cash & ST Invt	21,692	23,874	23,528	25,128	28,102
Inventory	1,974	1,677	1,492	1,567	1,645
Debtors	27,865	27,827	29,356	30,824	32,365
Other Current Assets	21,721	22,885	24,899	24,899	24,899
Total Assets	87,541	94,489	100,028	104,504	109,281
ST Debt	511	704	723	723	723
Creditors	39,405	42,864	45,411	47,681	50,065
Other Current Liab	10,768	11,661	12,180	12,205	12,236
LT Debt	0	0	90	90	90
Other LT Liabilities	1,819	2,073	2,015	2,015	2,015
Shareholder's Equity	34,564	36,718	38,407	40,557	42,886
Minority Interests	474	469	1,203	1,233	1,265
Total Cap. & Liab.	87,541	94,489	100,028	104,504	109,281
Non-Cash Wkg. Capital	1,387	(2,136)	(1,843)	(2,596)	(3,392)
Net Cash/(Debt)	21,181	23,169	22,715	24,315	27,289
Debtors Turn (avg days)	85.8	82.9	77.9	74.7	72.8
Creditors Turn (avg days)	136.6	139.6	136.9	131.6	128.2
Inventory Turn (avg days)	7.5	6.2	4.9	4.3	4.2
Asset Turnover (x)	1.4	1.3	1.4	1.4	1.5
Current Ratio (x)	1.4	1.4	1.4	1.4	1.4
Quick Ratio (x)	1.0	0.9	0.9	0.9	1.0
Net Debt/Equity (X)	CASH	CASH	CASH	CASH	CASH
Net Debt/Equity ex MI (X)	CASH	CASH	CASH	CASH	CASH
Capex to Debt (%)	183.7	498.9	199.5	212.3	223.5
Z-Score (X)	2.4	2.5	2.6	2.6	2.6

Source: Company, DBS HK

Cash Flow Statement (RMB m)

FY Dec	2019A	2020A	2021A	2022F	2023F
Pre-Tax Profit	3,494	3,488	3,578	3,797	4,083
Dep. & Amort.	1,252	1,350	1,529	1,622	1,651
Tax Paid	(530)	(476)	(398)	(393)	(418)
Assoc. & JV Inc/(loss)	(148)	(169)	(92)	(92)	(92)
(Pft)/ Loss on disposal of FAs	0	0	0	0	0
Chg in Wkg. Cap.	908	1,426	(1,017)	728	765
Other Operating CF	(163)	(165)	906	(87)	(87)
Net Operating CF	4,812	5,453	4,506	5,576	5,902
Capital Exp. (net)	(939)	(3,515)	(1,622)	(1,726)	(1,817)
Other Invt. (net)	413	1,551	0	0	0
Invt in Assoc. & JV	0	0	0	0	0
Div from Assoc & JV	208	298	162	162	162
Other Investing CF	7	(578)	(2,210)	(1,213)	0
Net Investing CF	(311)	(2,244)	(3,670)	(2,777)	(1,655)
Div Paid	(1,062)	(1,108)	(1,110)	(1,200)	(1,273)
Chg in Gross Debt	27	222	108	0	0
Capital Issues	0	0	0	0	0
Other Financing CF	(350)	(468)	373	0	0
Net Financing CF	(1,385)	(1,354)	(628)	(1,200)	(1,273)
Currency Adjustments	(1)	(68)	(46)	0	0
Chg in Cash	3,115	1,788	163	1,600	2,974
Opg CFPS (RMB)	0.56	0.58	0.80	0.70	0.74
Free CFPS (RMB)	0.56	0.28	0.42	0.56	0.59

Source: Company, DBS HK

China Communications Services

Target Price & Ratings History



S.No.	Date	Closing Price	12-mth Target Price	Rating
1:	13-Apr-21	HK\$3.51	HK\$4.40	Buy
2:	8-Jul-21	HK\$3.52	HK\$4.40	Buy
3:	31-Aug-21	HK\$3.88	HK\$4.90	Buy

Source: DBS HK

Analyst: Tsz Wang Tam

Harry Zhuang

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STRONG BUY (>20% total return over the next 3 months, with identifiable share price catalysts within this time frame)

BUY (>15% total return over the next 12 months for small caps, >10% for large caps)

HOLD (-10% to +15% total return over the next 12 months for small caps, -10% to +10% for large caps)

FULLY VALUED (negative total return, i.e., > -10% over the next 12 months)

SELL (negative total return of > -20% over the next 3 months, with identifiable share price catalysts within this time frame)

*Share price appreciation + dividends

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