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Huawei: Escalation or a deal, but not life on the Entities List

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Huawei: Escalation or a deal, but *not* life on the Entities List

The interventions by ARM and Google illustrate very clearly how very little Huawei's dilemma has to do with the level of 'chip inventories' in its warehouses. The global technology ecosystem is a web of continuous engagement between firms whose subsystems must function together through continuous change. Interleaved intellectual property sharing is the lifeblood of this ecosystem. The Entities List is choking off this lifeblood for Huawei.

What does this mean for Huawei?

- Huawei cannot continue as a world leading vendor if it remains on the US 'Entities List', even if the selective 90-day waivers are repeatedly extended by the US authorities. Huawei needs its close relationships with ARM, Cadence, Synopsys, Google and a hundred other partners if it is to maintain its position in the front rank of global vendors. These relationships cannot function if Huawei is on the Entities List, irrespective of selective short 'stays of execution'. The theoretical 'self-sufficiency' of China in technology in five or ten years' time is irrelevant – Huawei cannot be self sufficient in 2019 or 2020, so its leading status *will* slip if it remains on the list.
- China will not let Huawei slip from the front rank of global vendors without taking action.
- . . . so either China will deal with the US that results in removal from the Entities List (as happened with ZTE's Denied Person status last year) . . .
- . . . or China will escalate matters – probably through the disruption of US tech supply chains for one or more US firms
- Either way, the current situation will not persist for long – It will materially improve or it will materially deteriorate, probably within weeks (rather than months)
- We don't have a consensus view on the matter within New Street. Whereas our tech team is more optimistic and expects a deal in the next six weeks (here), the telco teams sees a more equal chance of escalation as a next step. We all agree nothing is clear cut and we are in a period of heightened uncertainty.
- On the bearish side, our arguments are that there are hawkish elements close to the decision making in Washington and in Beijing, who may see advantages in provoking the other side into rash responses. China may see an escalation, or a threat of specific escalation, as necessary to signal the urgency and importance of bringing the US to the table;
- On the optimistic side, our argument is that both sides can achieve their goals without further escalation. The US does not need to crush Huawei to reset its trade relationships with China, particularly if crushing Huawei involves material harm to its own tech champions. The President's concession that "*it's possible that Huawei even would be included in some kind of a trade deal*" would align with this reading;

What does this mean for telecoms and tech?

1. There is no point in trying to work out the impact of 'life on the Entities List' for Huawei's suppliers or its customers in the medium or longer term. Either Huawei will come off the list, or the situation will get much worse. A continuation of the status quo is not plausible in our view.
2. For the Chinese carriers, the sanguine share price response would suggest that the market is thinking about this from the perspective of what would be the right thing to do for the telcos rather than what is right for China. In our

view this is why the market has underestimated 3G, 4G and now 5G capex, as the carriers do not take these decisions, the Government does. The market is therefore viewing the situation as telco positive as it potentially delays 5G. But from the perspective of the Chinese govt and how it pertains to the telcos there are only two outcomes that are relevant: either Huawei stays on the Entities List or it doesn't. As we wrote (HERE), implications of either outcome are negative in our view. If Huawei remains on the Entities List there will be an attempt to keep the company afloat for as long as possible. If Huawei loses its overseas business that will not be seen as an opportunity for the Chinese carriers to cut back too. The carriers are likely to be strong-armed into purchasing equipment that may well be defunct in years to come, beyond the point at which it makes commercial sense to keep doing so. Or they may be asked to pay higher unit prices. They may even be required to invest in some sort of "war fund" to support the company. If there is an agreement/de-escalation that involves Huawei coming off the list, then the genie does not just go back into the bottle: China's priority will be striving for tech independence as rapidly as possible. This likely would also involve a more aggressive capex plan by the MNOs than has previously been envisaged.

   1. For China Tower (and by implication Unicom – see HERE), the outcomes are more binary. If Huawei remains on the Entities List this is fundamentally negative for the towerco; if it comes off the Entities List, fundamentally positive (driven by carrier capex).
   2. For the last 15 years investors have asked whether they "own" China Mobile's cash pile, currently RMB 349bn (US$ 50bn), or whether it is in some way restricted and unlikely to ever be paid out to shareholders. We may be about to find out, and in our view investors in the company might not like the answer.

3. Escalation by China may target specific US firms but is likely to hurt sentiment across the board in global tech. An escalation by China is very likely to trigger a further escalation by the US. However, it is futile to speculate on the scale or mix of these impact (in our view) – the range of scenarios is too great for sensible analysis.
4. A deal to remove Huawei from the Entities List would calm sentiment to a degree, but markets would have no doubt that tech would remain a key bargaining chip in the wider US-China trade dispute. As Pierre wrote in the note referred to earlier (here), in this scenario "*stock markets rally across the board and all names hit in recent days outperform. Ericsson and Nokia give back their relative gains, and the second half recovery is still on".*
5. Global telcos (ex-China and ex-US) will have a continuing dilemma in doing business with Huawei, either for 4G or 5G. We would expect most to continue to include Huawei in their access networks and handset offerings, at least to a degree. In many cases this may give network operators a good excuse for slowing the pace of 5G capex. (We already expect a slow pace in most of Europe, after the excitement of initial launch coverage has passed, so this further slowdown may be hard to detect).

In summary, we have entered a dangerous period, with unpredictable outcomes, some of which could be very negative. We are not in steady state – China will not let Huawei be choked by the US without a reaction – so a steady state analysis is not useful.

As analysts, it is important for us to recognise the limitations of analysis, and highlight these limitations to investors.