Making it Big in China

February 16, 2019 by Chris Hoare

This week we wrote again (HERE) on the outlook for 5G capex in China. Capex is always a (the?) key driver for the Chinese telcos, but with the National People's Congress approaching (5th March), and the telcos likely to announce 2019 capex budgets at their full year results towards the end of March, and probably give some indication of spend in 2020, the likely shape of 5G spend is set to be the definitive catalyst for the stocks over the next few months.

And the capex outlook seems to be changing. We wrote 3 weeks ago (HERE) about our changing view that even in a steady state environment capex would likely be ahead of expectations as the government looks to promote increased investment to boost the economy and the telcos end up paying higher unit prices for 5G equipment in order to support Huawei. In that note we downgraded China Mobile and China Telecom to Neutral. But we didn't change our base case that the Chinese government would be opting for a "steady state" approach to 5G.

But our note this weak looked into the possibility that a bigger change may be in the works. We argue that by focusing on the cost/benefit to the telcos the market always has a tendency to ignore the benefits the Chinese economy has historically received from "overinvestment" seen through a telco lens. 5G opens up use cases that might appeal to the government even while offering only limited revenue opportunities for the telcos in areas such as autonomous driving, smart cities, facial recognition and security. Much as past investment in 3G and 4G has created the Chinese internet economy, stimulating huge growth and change in the country even while the telcos have struggled to monetise that investment. This has always been the case but up until recently we felt the interests of the telcos, the government and the equipment industry were aligned in a "steady state" approach in 5G. But the backdrop has changed. China is under substantial pressure from trade wars, economic slowdown and the "attack" on Huawei & ZTE. Criminal charges in the US against Huawei in particular open up the possibility of technology disruption in a way China 2.0 has not previously experienced. Achieving technology independence is therefore an existential requirement for the Chinese government. This note attempts to address the question of what a radical response might be as the previous close alignment of interest between the telcos, the govt and the equipment industry diverges.

The conclusion is that there is an increasing risk in the "extreme" route. The canary in the coal mine on how the Chinese may be thinking about this could prove to have been the announcement by the CAICT (research arm of MIIT) in 2017 that combined 5G capex for the industry would be $440bn in 2020-2030, with a peak of $47bn in 2023, well ahead even of our "extreme" case. Our "extreme roll" would incorporate a doubling in the number of 5G base stations in the country relative to previous expectations by 2025. This would take Chinese 5G geographic coverage to c. 55% and population coverage to 98%. Even assuming a joint network build by China Telecom and China Unicom it would see peak capex c. 25% higher than consensus for the telco industry, and a 4% margin squeeze on higher lease payments to China Tower. Bad news therefore for all 3 and even though we only ascribe a 30% probability to such an outcome we downgraded China Mobile and China Telecom to Reduce and China Unicom to Neutral. The telcos have traded well into this environment and are now at peak multiples as consensus capex expectations have fallen materially, and the buyside is much less concerned about this issue than it should be we think; this opens up substantial risk of a material sell-off if higher than expected capex is announced. Higher lease fees offset the higher capex requirements for China Tower which is in our view now by far the best investment opportunity in the Chinese telcos space. We remain Buyers of the latter with a price target of HK$ 2.30 (HERE, HERE and HERE).

For the full weekly review and updated comp sheets, see HERE.
