

**BEA securities**

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**HONG KONG RESEARCH****27<sup>th</sup> November 2006****Analyst: Vincent Leung****Main Board H-share Listing – Research**

中國通信服務股份有限公司

China Communications Services Corporation Limited [Stock Code: 0552]**Joint Global Coordinators, Joint Bookrunners,  
Joint Sponsors and Joint Lead Managers**

:

Goldman Sachs

CICC

**Sector** : Telecoms**Business** : Provision of integrated specialized telecommunications support services in the PRC

<b>Total H share offer:</b> <u>1,291,293,000</u> H shares <b>(24.6% of the enlarged share capital)</b>  <b>Public Offer:</b> 129,132,000 H shares (10%) <b>Placing:</b> 1,162,161,000 H shares (90%) <b>Greenshoe:</b> 193,693,000 H shares	<b><u>Business of China Communications Services (CCS)</u></b>  Being a subsidiary of China Telecom Group, CCS is a leading integrated provider of specialised telecom support services to telecom operators in the PRC. CCS' operations are primarily in Fujian, Shanghai, Guangdong, Zhejiang, Hubei and Hainan.  CCS' services include telecoms infrastructure service (TIS), business process outsourcing (BPO) as well as applications, content and other IT services (ACO). The TIS segment includes design, construction as well as project supervision and management of telecom infrastructure-related projects. The BPO segment includes network maintenance, facilities management and distribution of telecom services and products. The ACO segment includes a variety of value-added telecom and IT services, such as IT applications, Internet services, value-added voice services, etc.  All five major telecom operators in the PRC are the customers of CCS. In fact, China Telecom Group, China Mobile Communications Corporation and China United Communications Corporation are the key customers. Revenue from these three companies represented approximately 62.7% and 65.7% of CCS' total revenue for the year ended 31 <sup>st</sup> December 2005 and the six months ended 30 <sup>th</sup> June 2006 respectively. China Telecom Group is the single largest customer of CCS, contributing approximately 45.2% and 51.2% of the Group's total revenue for the year ended 31 <sup>st</sup> December 2005 and the six months ended 30 <sup>th</sup> June 2006 respectively.
<b>Price:</b> HK\$1.70 – HK\$2.20 per H share  <b>H-share Market Cap:</b> HK\$2,415 million – HK\$3,125 million  <b>FY2006E P/E:</b> 14.1x – 18.3x (pro-forma fully-diluted)  <b>Adjusted NTA per share:</b> HK\$1.30 – HK\$1.41  <b>Staffing:</b> 73,458 (as of 31 <sup>st</sup> December 2005)	
<b>HK Public Offer period:</b> 27 <sup>th</sup> November 2006 – 30 <sup>th</sup> November 2006 noon  <b>Receiving banks:</b> ICBC (Asia), Standard Chartered Bank (HK), The Bank of East Asia  <b>Share registrar:</b> Computershare Hong Kong Investor Services Limited  <b>Listing date:</b> 8 <sup>th</sup> December 2006	

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**Shareholding Structure after Listing** (Assuming the over-allotment option is not exercised)

China Telecom Group (Domestic shares)	66.75%
Guangdong Telecom Industry (Domestic shares)	4.52%
Zhejiang Telecom Industry (Domestic shares)	1.68%
The National Council for Social Security Fund of the PRC (H shares)	2.46%
Other public shareholders* (H shares)	24.59%
	<u>100.00%</u>

Remark (\*): CISCO and International Data Group have agreed to subscribe for US\$50 million and US\$10 million worth of shares respectively in the Global Offering. Assuming an issue price of HK\$1.95 each, being the midpoint of the indicative price range, shareholdings of CISCO and International Data Group in CCS are equivalent to 3.79% and 0.76% of the enlarged share capital. H shares purchased by CISCO and International Data Group in the global offerings are subject to lock-up periods of 18 months and 6 months from the listing date respectively.

Note: According to an agreement, after a year from the listing date, Guangdong Telecom Industry and Zhejiang Telecom Industry will transfer their shareholdings in CCS to China Telecom Group for nil consideration, and China Telecom Group will transfer 506.88 million shares (or 9.65% of the enlarged share capital, assuming over-allotment option is not exercised) to China Mobile Communications Corporation (parent of China Mobile (stock code: 0941)) and no more than 4.50% of the enlarged share capital assuming over-allotment option is not exercised) to China United Communications Corporation (parent of China Unicom (stock code: 0762)). China Telecom Group's shareholding in CCS will then be 58.80%.

**Use of Proceeds**

Net proceeds from the offer are estimated to be HK\$2,337 billion (Assuming the over-allotment option is not exercised, and at an issue price of HK\$1.95 each, being the midpoint of the indicative price range)

	HK\$ million
For the purchase of testing and construction equipment for the Company's design, construction and project supervision and management businesses, as well as large-scale maintenance equipment for its network maintenance business	467
For the purchase, development and/or upgrading the simulation and testing systems and applications development platforms for strategic new products in the Company's IT and Internet services	350
For the development of business capabilities associated with 3G technology and applications and applications	234
For upgrading the Company's existing premises and/or adding new premises to house its production and R&D facilities	117
For the implementation of the Company's business strategies and funding of business expansion, including potential selective acquisitions from China Telecom Group and other strategic investments	935
For general working capital	Balance

**Financial Highlights**

	Year ended 31 <sup>st</sup> December			Six months ended 30 <sup>th</sup> June
	2003	2004	2005	2006
	RMB million	RMB million	RMB million	RMB million
Revenues	10,917.3	12,248.8	13,232.3	6,372.2
Gross profit	2,278.4	2,374.2	2,687.9	1,164.6
Operating profit	728.4	773.1	831.4	451.7
<b>Net profit</b>	<b>458.4</b>	<b>525.6</b>	<b>597.6</b>	<b>194.1</b>
Gross margin	20.9%	19.4%	20.3%	18.3%
Operating margin	6.7%	6.3%	6.3%	7.1%
Net margin	4.2%	4.3%	4.5%	3.0%

**Revenue Breakdown (% of Total Revenues)**

	Year ended 31 <sup>st</sup> December			Six months ended 30 <sup>th</sup> June
	2003 %	2004 %	2005 %	2006 %
Telecoms infrastructure service (TIS)	61.3%	59.1%	54.4%	49.4%
business process outsourcing (BPO)	28.9%	29.7%	33.0%	38.6%
Applications, content and other IT services (ACO)	9.8%	11.2%	12.6%	12.0%
Total	100.0%	100.0%	100.0%	100.0%

**Strengths/Opportunities**

- ✓ As an integrated one-stop service provider, CCS should benefit from the rising outsourcing trend in China's telecom industry as operators are seeking ways to save costs and improve efficiency.
- ✓ Leveraging on its strong and long-established ties with leading Chinese telecom players, including China Telecom Group, China Mobile Communications Corporation and China United Communications Corporation, CCS is expected to further enhance its market share in all three of its business divisions.
- ✓ CCS stands to benefit from 3G deployment regardless of the 3G licensing scenario and the form of technology eventually used. CAPEX in the 3G network rollout should be a strong impetus to CCS' growth.
- ✓ CCS expects to pay out at least 40% of its net profit as dividends from 2007.
- ✓ CCS has a strong balance sheet, with net cash of RMB 2 billion as of 30<sup>th</sup> June 2006.
- ✓ CCS' parent China Telecom Group currently operates specialised telecom support business in 21 provinces and municipalities while CCS' primary service regions only include six. In fact, CCS plans to acquire appropriate assets from its parent within the next 12 to 18 months. Supported by CCS' strong cash position, the acquisition could further propel earnings growth.
- ✓ There is no real direct comparables listing in Hong Kong given CCS' uniqueness as a network support service provider in China. However, CCS' valuation of 14.1x-18.3x FY2006E P/E is not demanding when compared with telecom equipment providers ZTE Corp (stock code: 0763) and Comba Telecom Systems (stock code: 2342), which are also China 3G-concept plays as they provide network construction and antenna installation services. ZTE and Comba are trading at FY2006E P/E of 34.4x and 24.6x respectively.

**Weaknesses/Threats**

- × Slowdown or declining trend for Chinese telecom operators' CAPEX excluding 3G over the long term would weigh on CCS' top line and earnings.
- × 3G-related CAPEX investment will be a major accelerator for CCS' revenue and earnings. Delays to 3G deployment are major concerns.
- × CCS is heavily reliant on the three key customers, namely China Telecom Group, China Mobile Communications Corporation and China United Communications Corporation. The trio generated over 60% of CCS' revenue in the past three years ended 31<sup>st</sup> December 2005 and the six months ended 30<sup>th</sup> June 2006. Any slowdown or cutback in these telecom operators' CAPEX and OPEX plan will have a negative impact on CCS' revenue and earnings.

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