

Analyst: Kelvin Li

Main Board Listing - Research

中國網通集團(香港)有限公司

China Netcom Group Corporation (Hong Kong) Limited [Stock Code: 0906]

Joint Global Coordinators and : China International Capital Corporation Limited
Joint Bookrunners Citigroup Global Markets Asia Limited
Goldman Sachs (Asia) L.L.C.

Sector : Telecommunication services
Business : Fixed-line telecommunications operator in China

Total share offer: <u>1,045,984,000</u> shares (16.2% of the enlarged share capital) Public Offer: 104,598,000 shares (10%) Placing: 941,386,000 shares (90%) Greenshoe: 156,897,000 shares	<u>Business of China Netcom</u> The Group is a leading fixed-line telecom operator in China and a leading international data-communications operator in the Asia-Pacific region. It operates comprehensive local networks in six service areas in northern China (Beijing, Tianjin, Hebei, Henan, Shandong and Liaoning) and two service areas in the south (Shanghai and Guangdong). Besides, the Group also operates a regional fibre-optic sub-marine cable system, owned by its Parent, connecting the Asia Pacific region as well as the west coast of the US, Australia and some of SE Asia countries via purchased or leased circuits. China Netcom is now the world's second largest fixed-line operator in terms of number of subscribers, behind China Telecom (0728), with a 95% share of the local fixed-line market in northern China. The Group offers its subscribers a variety of services including fixed-lined, PHS, broadband (including DSL and FTTx + Lan), business and data-communications services (including managed-data and leased-line services) and international services (including voice, managed-data and leased-line services).
Price: HK\$7.80 – HK\$8.91 per share Market Cap.: HK\$50.3 billion – HK\$57.5 billion Forecast FY2004 P/E: 6.0x – 6.8x (Pro forma diluted) Adjusted NTA per share: HK\$7.33 – HK\$7.49 Staffing: 99,986 (as of 31 st December 2003)	
HK Public Offer period: 4 th November 2004 - 9 th November 2004 Receiving bank: Bank of China (HK) The Bank of East Asia ICBC (Asia) Share registrar: Computershare Hong Kong Investor Services Limited Listing date: 17 th November 2004 (HK)	

Major Shareholders after Listing (Assuming the over-allotment option is not exercised)

China Netcom Group	72.3%
CNC Fund	6.9%
Shandong SASAC	2.3%
The Academy of Sciences, INC-SARFT, CRTC and Shanghai Alliance*	2.3%
	<u>83.8%</u>

*each party owns approximately 0.6% of the Group's outstanding shares.

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Use of Proceeds

Net proceeds from the offer are estimated to be HK\$7,521 million

(Assuming the over-allotment option is not exercised, and at an issue price of HK\$8.36 each, which is the mid-point of the indicative price range)

	HK\$ million
For expansion and upgrading of the Group's telecommunications network infrastructure.	3,761
For repayment of bank loans and a term loan facility between Asia Netcom, a wholly owned subsidiary of the Group, and a syndicate of financial institutions.	2,256
For development of new applications and services including new IP-based data communication applications and services and voice value-added services.	752
For general corporate purposes such as working capital and business expansion	752

Financial Highlights

	6 months ended 30 th June 2004 RMB in million	2003 RMB in million	2002 RMB in million	2001 RMB in million
Turnover	32,498	59,898	54,443	48,632
Operating profit / (loss)	8,601	(14,489)	11,581	11,942
Net profit / (loss)	4,875	(11,111)	6,520	7,400
EPS	RMB0.89	RMB(2.02)	RMB1.19	RMB1.35

Breakdown of Turnover by Business Segments

	6 months ended 30 th June 2004		2003		2002		2001	
	RMB in million	%	RMB in million	%	RMB in million	%	RMB in million	%
Fixed-line	26,714	82.2	50,533	84.4	47,135	86.6	42,545	87.5
Broadband and Internet	2,428	7.5	3,493	5.8	2,189	4.0	1,384	2.8
Business and data	1,567	4.8	3,661	6.1	3,373	6.2	2,986	6.1
Other	514							
Domestic business		1.6	832	1.4	1,174	2.2	1,539	3.2
International business	1,275	3.9	1,379	2.3	572	1.0	178	0.4
Turnover	<u>32,498</u>	100.0	<u>59,898</u>	100.0	<u>54,443</u>	100.0	<u>48,632</u>	100.0

Strengths/Opportunities

- ✓ The Group is a de facto monopoly in its northern fixed-line service areas with a market share of about 95%. Moreover, the fixed-line segment, core business of the Group, grew steadily in the last couple of years not only in terms of subscribers but also in terms of revenue. In the end of 1H2004, China Netcom has a total 77.552 million subscribers, 11.4% higher than 69.614 million as of 31/12/2003. With a penetration rate of 22.4% in the northern service areas and an overall 20.3% in both north & south, we see there is still ample room for growth in the Group's fixed-line business.
- ✓ Besides traditional telephony services, the Group's value-added service (VAS) segment also saw solid growth in recent years. VAS, including caller-ID, telephone-information services, teleconferencing, video conferencing, voice mail and PHS short-messaging, contributed a total revenue of RMB1.516 billion in 2003, 76% y-o-y higher than that of 2002. We expect VAS would be one of the Group's growth drivers in the future.

- ✓ China Netcom is also a leading player in the mainland's broadband market. As of 30th June 2004, the Group has 4.14 million broadband service subscribers, growth of 65.5% h-o-h and represented a market share of 92.9% in the northern service areas. We see Netcom is well-positioned to capture the opportunities arise from the fast-growing broadband market in China.
- ✓ Apart from the northern market, the Group has also operations in two southern service areas including Shanghai and Guangdong. Despite accounted for only a small part of business in the Group, revenue from the segment posted stable double-digit growth in the last two years. Moreover, as the overall usage and subscription continued to rise, we expect business in the southern service areas should keep growing fast and take a larger share in revenue in the future.
- ✓ The Group committed in a regulatory filing to keep its dividend payout ratio at 35%-40% in both 2004 and 2005, which would be higher than its rival China Telecom's (0728) 2003 payout ratio at 22%. With its median 2004E P/E at 6.4x and payout ratio at 37.5%, dividend yield of 2004 is estimated at 5.9%, which would be higher than 2%-3%+ among other major mainland telecom and mobile carriers. We expect such high expected dividend yield should receive warm welcome from the market.
- ✓ At the low end of the indicative price range, China Netcom is valued at about HK\$50.3 billion. The Group would rank in the middle of all HSI constituents in terms of market capitalisation. Accordingly, there could be possibility that China Netcom soon may become one of the index components in the future.
- ✓ Listing of China Netcom's has already received good responses from institutional investors in terms of their orders for the placement shares. It was reported that Cheung Kong (0001) and Hutchison Whampoa (0013), plan to subscribe for up to US\$100 million worth of Netcom shares while Lee Shau-kee, chairman of Henderson Land (0012) plans to subscribe for as much as HK\$300 million worth of Netcom shares.

Weaknesses/Threats

- × In 1H2004, the Group repaid RMB1.7 billion worth of bank loans and settled distribution payment to owners of RMB7.3 billion, so as to lower its net debt position from RMB 63.926 billion as of 31st December 2003 to RMB 55.231 billion at the end of 1H2004. However, China Netcom's net debt-to-equity is still at high level of 129% (31/12/2003: 147%).
- × International long distance (ILD) business is under rising competition pressure from lower-tariff VoIP long-distance call services. In 1H2004, ILD revenue totalled RMB 673 million, 11% lower than RMB 752 million in a year earlier.
- × Both China Netcom and rival China Telecom (0728) have operations in Shanghai and Guangdong. However, Netcom is a relatively small player in these two southern service areas and it may experience tough competitive pressure from China Telecom in coming years.
- × The Group's Vice President and non-executive Director Mr. Leng Rongquan will move to rival China Telecom (0728) amid a top-level personnel reshuffle in mainland's telecom industry. However, as Netcom revealed that its senior management would stay, we could expect the impact of the personnel change on business operation to be kept at minimal.

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