

ZTE (000063 CH)

A defensive play with long runway for growth

- **ZTE's recent update on AI-related development:** At a recent investor relations event, the Company shed light on its progress in AI development for the B2B sector. The Company featured a foundational AI model, a R&D model (AI-assisted programming), a telecom model (streamline telecom carriers' operations), and an industry-specific model (focusing on urban governance) aimed to be rolled out between year-end and early 2024. Capitalizing on the AI momentum spurred by ChatGPT in 1H23, the Company is set to debut new computational products and is on track to launch an AI server, specifically engineered for intensive model training.
- **We observe rising popularity of satellite communication, as Huawei's Mate60Pro could support satellite calling.** ZTE's Axon 50 Ultra can also facilitate two-way communication (messages) via the BeiDou satellite system. In a recent milestone, ZTE partnered with China Telecom, UNISOC and Vivo and achieved the first-ever domestic 5G NTN (non-terrestrial network) field test in China. This accomplishment signifies the successful establishment of a bi-directional connection for 5G NTN mobile phones, directly linked to satellites in a real-world setting. We believe ZTE will be a key beneficiary in this market, considering more consumer electronics will be equipped with satellite communications.
- **5G to 6G, into the next chapter:** With increasing interest in satellite communications, the market is waiting for the progress of 6G development. CAICT predicted that the number of 6G terminal connections of various types will increase by more than 30 times compared to 2022, and the average monthly traffic will increase by more than 130 times, which will significantly drive the demand for telecommunication equipment. Given ZTE's strong presence in the relevant fields, it is well-positioned to extend its leadership into the 6G competition.
- **H-share: maintain BUY with unchanged TP of HK\$29.4. We update TP of A-share to RMB39.5 based on 16.5x (3-year avg.) rollover FY24E P/E. Maintain BUY.** Currently, the Company is experiencing steady growth, marked by a continuous increase in market share and a noticeable enhancement in gross profit margins. Key areas of focus include: 1) the Company's progress in the server market, especially for AI servers, 2) the development and commercialization progress of foundational large models in their v2.0 iteration, 3) R&D efforts in satellite communication, as well as investment opportunities in related industry chains, and 4) the latest development in the realm of 6G. Potential risks include China-US trade tensions, additional component restriction/technology ban, and 5G deployment delays.

Earnings Summary

(YE 31 Dec)	FY21A	FY22A	FY23E	FY24E	FY25E
Revenue (RMB mn)	114,522	122,954	132,278	144,074	156,765
YoY growth (%)	12.9%	7.4%	7.6%	8.9%	8.8%
Gross margin (%)	35.2%	37.2%	41.2%	41.0%	40.7%
Net profit (RMB mn)	6,813	8,080	9,886	11,653	13,312
YoY growth (%)	59.9	18.6	22.4	17.9	14.2
P/E (x)	26.5	22.8	19.0	16.5	14.3
ROE (%)	13.2	13.4	14.4	14.7	14.5
Diluted EPS (RMB)	1.47	1.71	2.05	2.40	2.74
Net gearing(%)	Net cash	Net cash	Net cash	Net cash	Net cash

Source: Company data, Bloomberg, CMBIGM estimates

BUY (Maintain)

Target Price	RMB39.5
(Previous TP	RMB41.7)
Up/Downside	+20.9%
Current Price	RMB32.68

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Stock Data

Mkt Cap (RMB mn)	151,833.3
Avg 3 mths t/o (RMB mn)	2,669.8
52w High/Low (HK\$)	45.54/20.52
Total Issued Shares (mn)	NA

Source: FactSet

Shareholding Structure

ZTE Holdings	23.86%
National Social Security Fund	1.82%

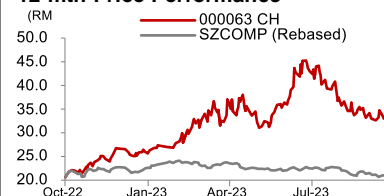
Source: Bloomberg

Share Performance

	Absolute	Relative
1-mth	-3.5%	-0.4%
3-mth	-24.5%	-19.2%
6-mth	-2.9%	9.8%

Source: FactSet

12-mth Price Performance

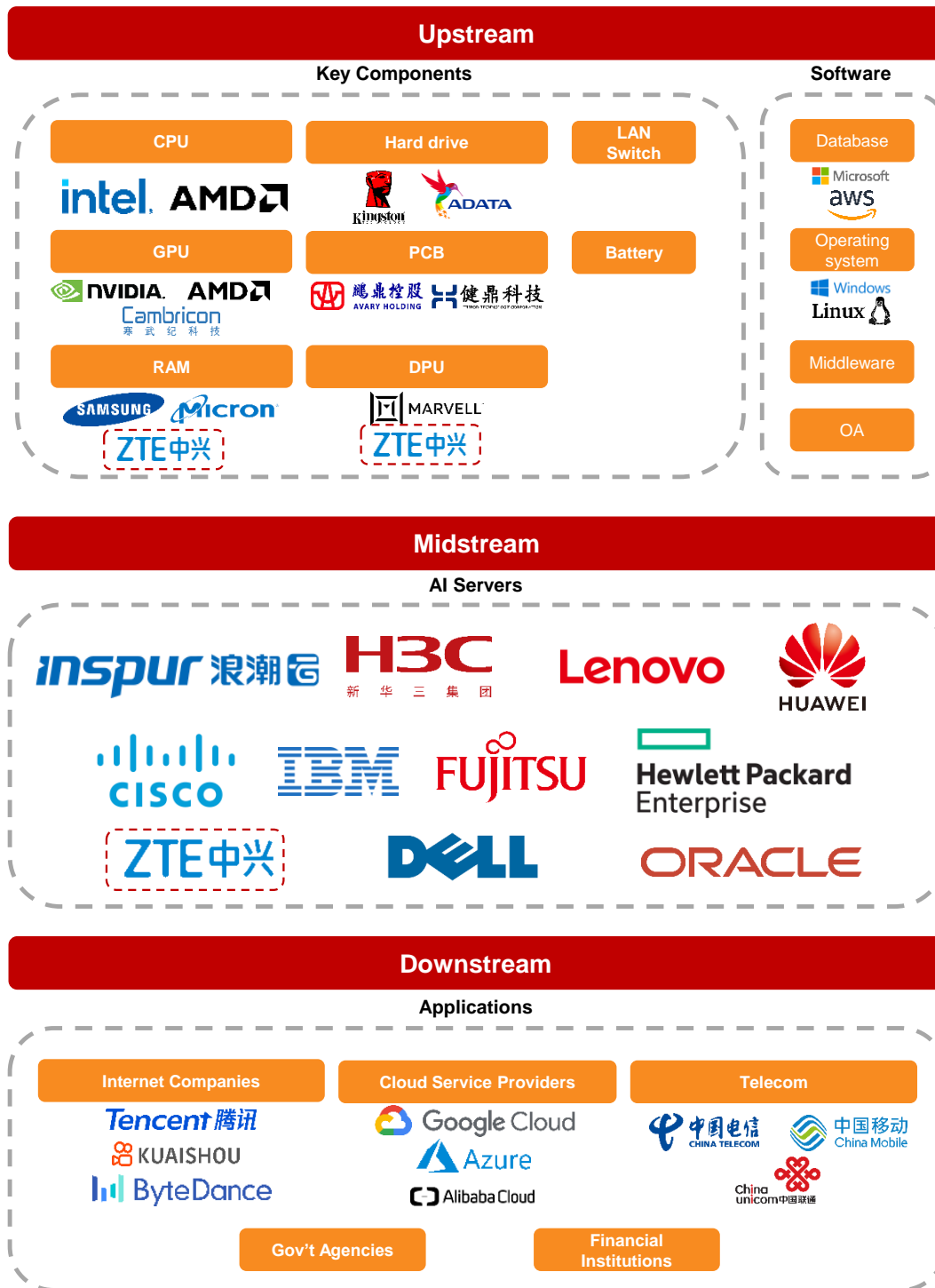


Source: FactSet

ZTE has a broad presence in the AI server ecosystem

In the field of computational infrastructure, ZTE already has a full range of servers and storage products, including general servers, GPU servers, liquid-cooled servers, as well as all-flash storage products and hybrid flash storage products, spanning across the majority of AI server ecosystem.

Figure 1: AI Server Value Chain



Source: CMBIGM estimates

While the industry is currently focused on large-scale generic models, the real concern for businesses should be on their value in specific industry applications. In view of this, ZTE is set to offer AI infrastructure services tailored to foundational models that span a wide range of knowledge zones. Not only will they provide comprehensive support for model training and logical reasoning, but also introduce specialized models targeting specific industry needs, ensuring an overall smooth digital transformation.

ZTE joining the satellite communication league

In 2022, amid a sluggish mobile market, satellite communication emerged as a vital breakthrough for many handset companies. Apple's iPhone 14 series introduced a satellite communication feature, albeit limited to only sending messages. Around the same time, Huawei launched its Mate50Pro, marking the company's entry into satellite communication phones. And in early 2023, ZTE released its Axon 50 Ultra that supported satellite messaging communication. This overall trend could also imply that satellite communication offers opportunities not just for handsets but also for various other consumer electronic products. As the mobile satellite communication value chain continues to evolve, there are significant prospects for telecom carriers, mobile companies, hardware & software developers, etc., to unlock the full potential of this new tech.

Figure 2: Satellite Communication Value Chain

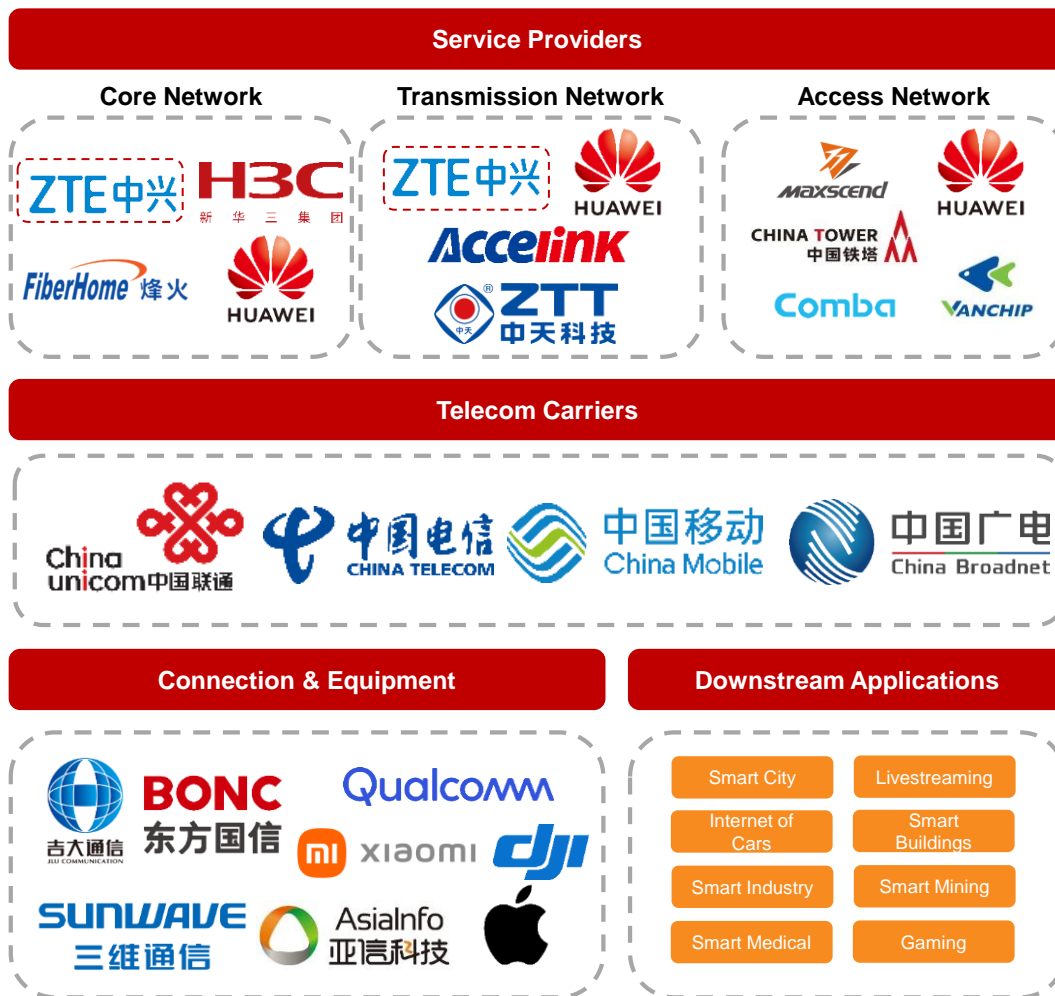


Source: CMBIGM estimates

ZTE to benefit from the transition from 5G to 6G

In 2020, ZTE entered into an agreement with China Unicom to collaborate on 6G technology. The Company outlined a research phase from 2020 to 2023 to explore network demands, structural aspects, and technological capabilities for 6G. By June 2023, the company publicly announced the commencement of research on crucial 6G technologies. ZTE anticipated that 6G would be a seamless evolution, building upon the success of 5G and 5G-advanced paradigm. Consequently, ZTE believed that their well-established technological expertise in 5G-related domains could be effectively extended to the realm of 6G.

Figure 3: 6G Network Value Chain



Source: CMBIGM estimates

Financial Summary

INCOME STATEMENT	2020A	2021A	2022A	2023E	2024E	2025E
YE 31 Dec (RMB mn)						
Revenue	101,451	114,522	122,954	132,278	144,074	156,765
Cost of goods sold	(69,379)	(74,160)	(77,228)	(77,724)	(85,000)	(92,954)
Gross profit	32,071	40,362	45,727	54,554	59,074	63,811
Operating expenses	(26,483)	(31,828)	(35,166)	(42,715)	(46,308)	(50,152)
Selling expense	(7,579)	(8,733)	(9,173)	(10,052)	(10,804)	(11,599)
Admin expense	(4,995)	(5,445)	(5,333)	(5,501)	(5,920)	(6,363)
Sales tax	(685)	(787)	(951)	(1,497)	(1,631)	(1,775)
R&D expense	(14,797)	(18,804)	(21,602)	(27,836)	(30,318)	(32,989)
Others	1,573	1,941	1,893	2,171	2,365	2,573
Operating profit	5,589	8,534	10,561	11,839	12,765	13,659
Other income/expense	(104)	928	(1,646)	(1,840)	(1,513)	(1,503)
EBIT	5,485	9,462	8,915	9,999	11,253	12,156
Other income/expense	(164)	(979)	(657)	0	0	0
Pre-tax profit	5,064	8,499	8,752	11,264	13,280	15,169
Income tax	(342)	(1,463)	(960)	(1,230)	(1,454)	(1,658)
After tax profit	4,722	7,036	7,792	10,034	11,827	13,511
Minority interest	(446)	(223)	289	(148)	(174)	(199)
Others	(16)	0	0	0	0	0
Net profit	4,260	6,813	8,080	9,886	11,653	13,312

BALANCE SHEET	2020A	2021A	2022A	2023E	2024E	2025E
YE 31 Dec (RMB mn)						
Current assets	106,977	127,871	137,874	146,851	162,909	179,050
Cash & equivalents	31,403	39,071	47,072	56,006	69,553	85,527
Restricted cash	4,256	11,642	9,274	8,387	8,387	8,387
Account receivables	15,891	17,509	17,751	17,039	18,091	18,846
Inventories	33,689	36,317	45,235	44,201	44,292	42,295
Other current assets	21,738	23,332	18,542	21,218	22,586	23,995
Non-current assets	43,658	40,892	43,080	42,190	43,718	45,376
PP&E	11,914	11,437	12,913	13,768	14,587	15,462
Right-of-use assets	1,047	815	1,080	1,031	1,008	1,009
Deferred income tax	3,437	3,195	3,719	3,773	4,124	4,480
Intangibles	9,367	8,905	7,342	8,143	7,891	7,291
Goodwill	186	0	0	0	0	0
Other non-current assets	17,707	16,540	18,026	15,475	16,108	17,134
Total assets	150,635	168,763	180,954	189,041	206,626	224,426
Current liabilities	74,395	78,685	78,424	72,759	80,938	86,590
Short-term borrowings	10,559	8,947	9,962	6,005	7,446	8,055
Account payables	17,152	21,717	19,075	19,576	21,397	23,240
Other current liabilities	46,684	48,021	49,387	47,178	52,095	55,295
Non-current liabilities	30,117	36,791	42,987	46,595	45,063	44,674
Long-term borrowings	22,614	29,908	35,126	38,334	36,033	34,866
Other non-current liabilities	7,503	6,883	7,861	8,261	9,030	9,808
Total liabilities	104,512	115,476	121,410	119,354	126,002	131,264
Share capital	4,613	4,731	4,736	4,827	4,865	4,865
Retained earnings	14,824	20,651	27,309	35,351	46,035	58,369
Other	23,860	26,100	26,596	28,459	28,501	28,506
Total shareholders equity	43,297	51,482	58,641	68,637	79,401	91,740
Minority interest	2,826	1,806	902	1,050	1,223	1,422
Total equity and liabilities	150,635	168,763	180,954	189,041	206,626	224,426

CASH FLOW	2020A	2021A	2022A	2023E	2024E	2025E
YE 31 Dec (RMB mn)						
Operating						
Profit before taxation	4,722	7,036	7,792	10,034	11,827	13,511
Depreciation & amortization	3,971	4,588	4,386	4,783	5,289	5,728
Change in working capital	(1,965)	2,616	(9,058)	1,870	(454)	(582)
Others	3,505	1,484	4,458	3	6,481	7,154
Net cash from operations	10,233	15,724	7,578	16,690	23,143	25,810
Investing						
Capital expenditure	(6,472)	(5,686)	(4,952)	(5,678)	(6,195)	(6,735)
Others	-610	-4,906	3,661	635	375	425
Net cash from investing	(7,082)	(10,592)	(1,291)	(5,043)	(5,820)	(6,310)
Financing						
Dividend paid	(2,951)	(2,618)	(3,688)	(3,904)	(2,992)	(2,968)
Net borrowings	(1,294)	5,309	5,442	(749)	(860)	(559)
Others	3,955	88	(299)	1,941	76	1
Net cash from financing	(290)	2,779	1,455	(2,712)	(3,776)	(3,526)
Net change in cash						
Cash at the beginning of the year	28,506	31,403	39,071	47,072	56,006	69,553
Exchange difference	37	(242)	260	0	0	0
Cash at the end of the year	31,403	39,071	47,072	56,006	69,553	85,527

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