

# 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	7,867	9,886	11,653	13,312
YoY growth (%)	59.9	15.5	25.7	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%

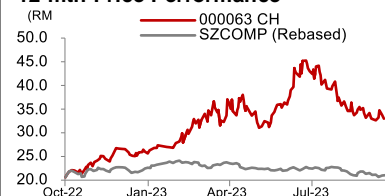
Source: Bloomberg

### 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

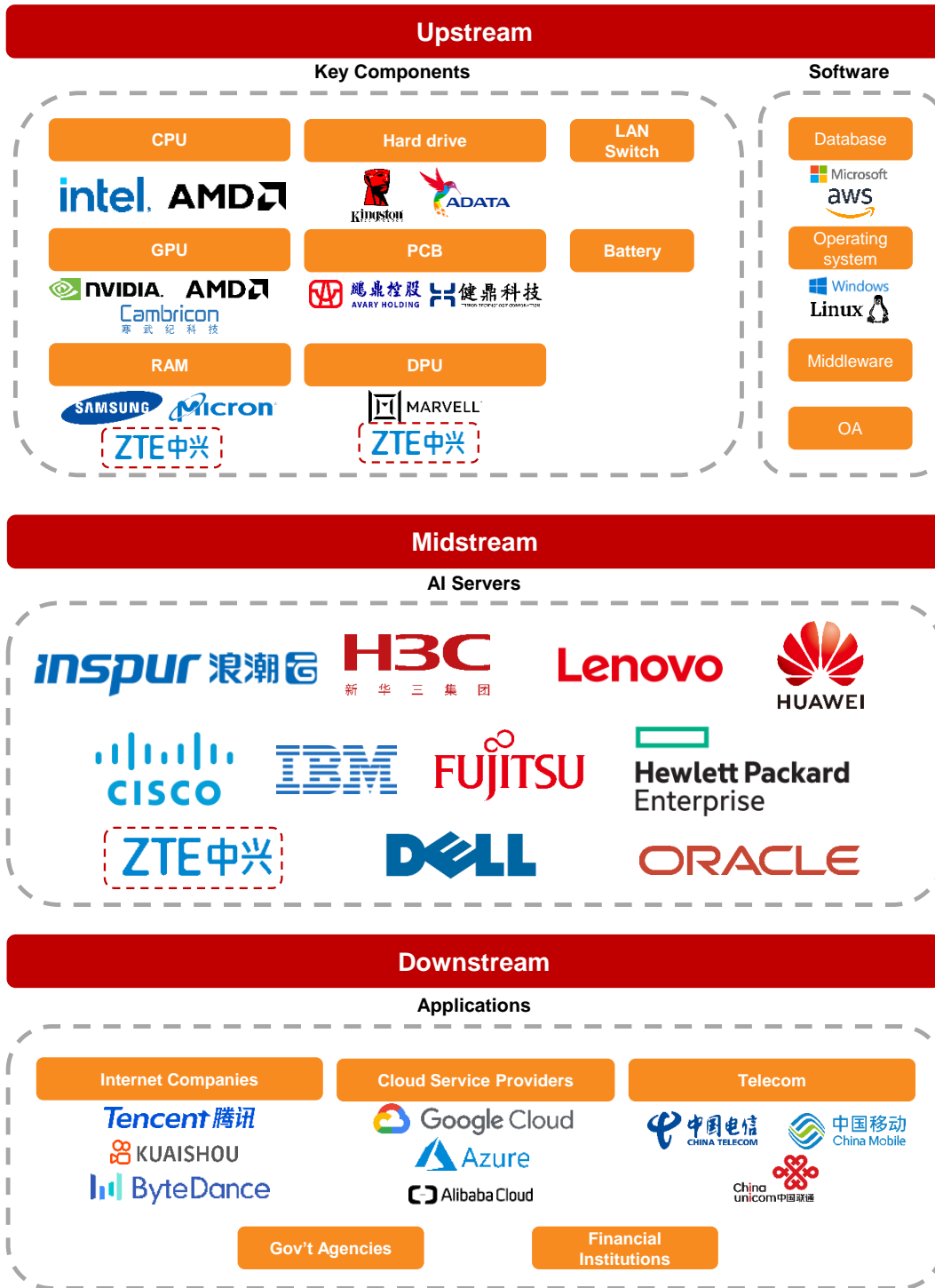


Source: FactSet

## 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**

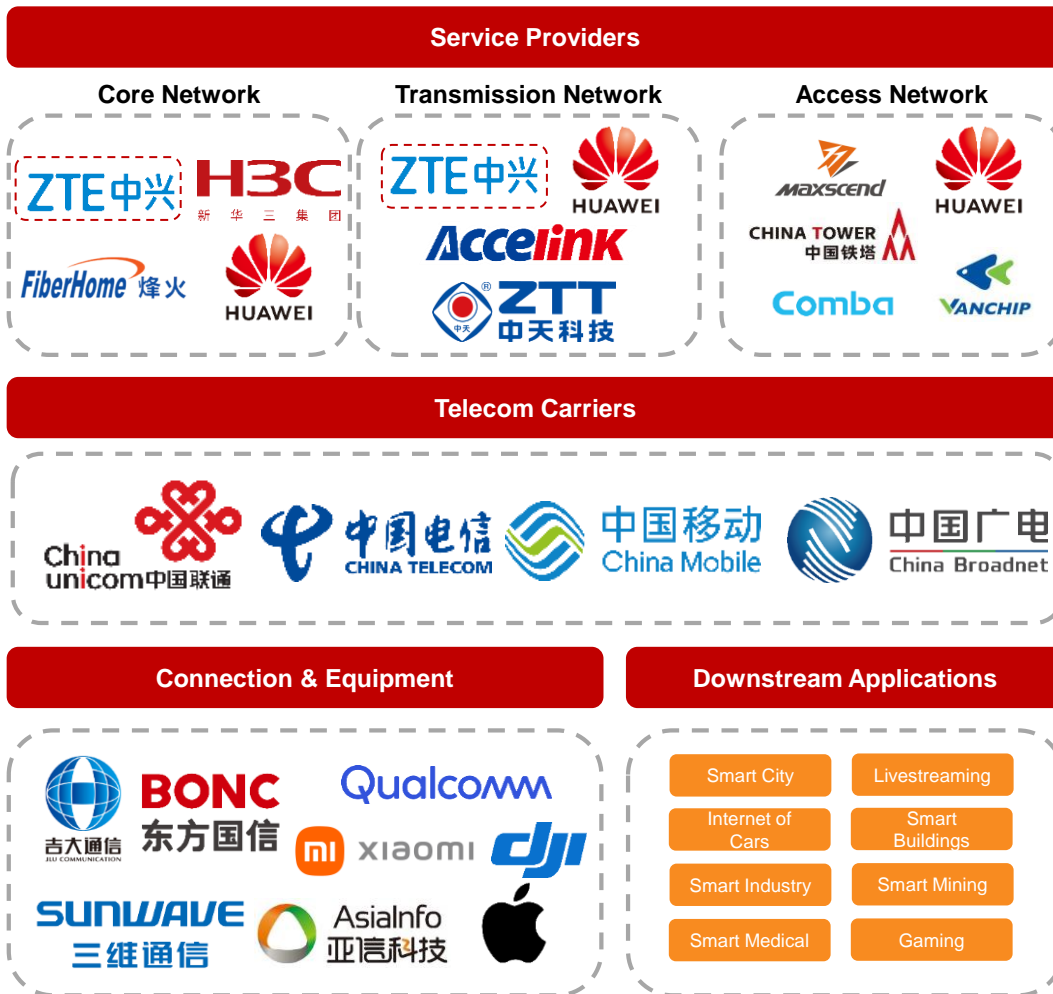


Source: CMBIGM estimates

## 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
<b>YE 31 Dec (RMB mn)</b>						
<b>Revenue</b>	<b>101,451</b>	<b>114,522</b>	<b>122,954</b>	<b>132,278</b>	<b>144,074</b>	<b>156,765</b>
Cost of goods sold	(69,379)	(74,160)	(77,228)	(77,724)	(85,000)	(92,954)
<b>Gross profit</b>	<b>32,071</b>	<b>40,362</b>	<b>45,727</b>	<b>54,554</b>	<b>59,074</b>	<b>63,811</b>
<b>Operating expenses</b>	<b>(26,483)</b>	<b>(31,828)</b>	<b>(35,166)</b>	<b>(42,715)</b>	<b>(46,308)</b>	<b>(50,152)</b>
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)
SG&A expense	(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
<b>Operating profit</b>	<b>5,589</b>	<b>8,534</b>	<b>10,561</b>	<b>11,839</b>	<b>12,765</b>	<b>13,659</b>
Other income	238	250	196	163	177	193
Other expense	(644)	(427)	(239)	(258)	(281)	(306)
Gain/loss on financial assets at FVTPL	39	1,099	(1,142)	(431)	0	0
Investment gain/loss	906	1,564	1,087	(417)	0	0
Other gains/(losses)	(643)	(1,558)	(1,548)	(897)	(1,409)	(1,390)
<b>EBIT</b>	<b>5,485</b>	<b>9,462</b>	<b>8,915</b>	<b>9,999</b>	<b>11,253</b>	<b>12,156</b>
<b>Net Interest income/(expense)</b>	<b>(421)</b>	<b>(963)</b>	<b>(163)</b>	<b>1,265</b>	<b>2,027</b>	<b>3,013</b>
Other income/expense	(164)	(979)	(657)	0	0	0
<b>Pre-tax profit</b>	<b>5,064</b>	<b>8,499</b>	<b>8,752</b>	<b>11,264</b>	<b>13,280</b>	<b>15,169</b>
Income tax	(342)	(1,463)	(960)	(1,230)	(1,454)	(1,658)
<b>After tax profit</b>	<b>4,722</b>	<b>7,036</b>	<b>7,792</b>	<b>10,034</b>	<b>11,827</b>	<b>13,511</b>
Minority interest	(446)	(223)	75	(148)	(174)	(199)
Others	(16)	0	0	0	0	0
<b>Net profit</b>	<b>4,260</b>	<b>6,813</b>	<b>7,867</b>	<b>9,886</b>	<b>11,653</b>	<b>13,312</b>
Net dividends	926	1,390	1,840	965	973	973

BALANCE SHEET	2020A	2021A	2022A	2023E	2024E	2025E
<b>YE 31 Dec (RMB mn)</b>						
<b>Current assets</b>	<b>106,977</b>	<b>127,871</b>	<b>137,874</b>	<b>146,851</b>	<b>162,909</b>	<b>179,050</b>
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	17,043	18,863	19,098	19,317	19,761	20,612
Inventories	33,689	36,317	45,235	44,201	44,292	42,295
Prepayment	322	607	279	506	535	591
Financial assets at FVTPL	1,037	1,361	514	431	471	512
Other current assets	19,226	20,011	16,402	18,003	19,910	21,127
<b>Non-current assets</b>	<b>43,658</b>	<b>40,892</b>	<b>43,080</b>	<b>42,190</b>	<b>43,718</b>	<b>45,376</b>
PP&E	12,954	12,810	13,877	14,594	15,402	16,315
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
Investment in JVs & assos	3,749	3,699	3,765	3,794	3,984	4,176
Intangibles	11,440	10,548	9,926	9,563	9,019	8,393
Goodwill	186	0	0	0	0	0
Financial assets at FVTPL	1,537	1,175	1,028	1,028	1,028	1,028
Other non-current assets	9,307	8,650	9,685	8,407	9,153	9,975
<b>Total assets</b>	<b>150,635</b>	<b>168,763</b>	<b>180,954</b>	<b>189,041</b>	<b>206,626</b>	<b>224,426</b>
<b>Current liabilities</b>	<b>78,685</b>	<b>74,395</b>	<b>78,424</b>	<b>72,759</b>	<b>80,938</b>	<b>86,590</b>
Short-term borrowings	8,947	10,559	9,962	6,005	7,446	8,055
Account payables	36,780	32,869	13,520	13,737	15,606	15,719
Tax payable	1,216	878	17,700	15,016	16,413	17,827
Other current liabilities	3,949	4,545	18,167	18,425	20,077	21,750
Contract liabilities	27,793	25,544	19,075	19,576	21,397	23,240
<b>Non-current liabilities</b>	<b>30,117</b>	<b>36,791</b>	<b>42,987</b>	<b>46,595</b>	<b>45,063</b>	<b>44,674</b>
Long-term borrowings	22,614	29,908	35,126	38,334	36,033	34,866
Bond payables	0	0	0	0	0	0
Obligations under finance leases	718	532	789	741	810	880
Deferred income	134	150	87	86	94	102
Other non-current liabilities	6,651	6,200	6,985	7,434	8,126	8,826
<b>Total liabilities</b>	<b>108,803</b>	<b>111,185</b>	<b>121,410</b>	<b>119,354</b>	<b>126,002</b>	<b>131,264</b>
Share capital	4,613	4,731	4,736	4,827	4,865	4,865
Capital surplus	(115)	0	0	0	0	0
Retained earnings	14,824	20,651	27,309	35,351	46,035	58,369

10 Oct 2023

Other reserves	23,974	26,100	26,596	28,459	28,501	28,506
<b>Total shareholders equity</b>	<b>43,297</b>	<b>51,482</b>	<b>58,641</b>	<b>68,637</b>	<b>79,401</b>	<b>91,740</b>
Minority interest	2,826	1,806	902	1,050	1,223	1,422
<b>Total equity and liabilities</b>	<b>154,925</b>	<b>164,473</b>	<b>180,954</b>	<b>189,041</b>	<b>206,626</b>	<b>224,426</b>

<b>CASH FLOW</b>	<b>2020A</b>	<b>2021A</b>	<b>2022A</b>	<b>2023E</b>	<b>2024E</b>	<b>2025E</b>
<b>YE 31 Dec (RMB mn)</b>						
<b>Operating</b>						
<b>Profit before taxation</b>	<b>4,722</b>	<b>7,036</b>	<b>7,792</b>	<b>10,034</b>	<b>11,827</b>	<b>13,511</b>
Depreciation & amortization	3,971	4,588	4,386	4,783	5,289	5,728
Tax paid	(963)	258	(587)	(56)	(343)	(347)
Change in working capital	(1,001)	2,357	(8,471)	1,926	(111)	(235)
Others	3,504	1,484	4,458	3	6,480	7,154
<b>Net cash from operations</b>	<b>10,233</b>	<b>15,724</b>	<b>7,578</b>	<b>16,690</b>	<b>23,143</b>	<b>25,810</b>
<b>Investing</b>						
Capital expenditure	(6,472)	(5,686)	(4,952)	(5,678)	(6,195)	(6,735)
Acquisition of subsidiaries/ investments	(620)	(5,127)	3,636	(795)	(230)	(233)
Net proceeds from disposal of short-term investments	9	221	24	542	605	658
Others	(10,218)	(450)	(471)	878	0	0
<b>Net cash from investing</b>	<b>(17,300)</b>	<b>(11,042)</b>	<b>(1,762)</b>	<b>(5,053)</b>	<b>(5,820)</b>	<b>(6,310)</b>
<b>Financing</b>						
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)
Proceeds from share issues	14,167	538	171	1,950	77	0
Others	(10,211)	(450)	(471)	(10)	0	0
<b>Net cash from financing</b>	<b>(290)</b>	<b>2,779</b>	<b>1,455</b>	<b>(2,712)</b>	<b>(3,776)</b>	<b>(3,526)</b>
<b>Net change in cash</b>						
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
Others	2,861	7,910	7,741	8,934	13,546	15,974
<b>Cash at the end of the year</b>	<b>31,403</b>	<b>39,071</b>	<b>47,072</b>	<b>56,006</b>	<b>69,553</b>	<b>85,527</b>

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