Strategy In-Depth

9 May 2007 | 11 pages

Asia ex Strategy

A Telco Today Brings Surplus Cash Your Way

- Telecoms has carried out more capital management than any other sector — The combination of strong free cash flows, 8.2% free cashflow yield and limited investment opportunities has led to great capital management focus. Singaporean, Malaysian and now Taiwanese telcos are all returning cash to shareholders. This should be positive for stock price performance.

- High free cash flow and high dividend yield are outperforming attributes — Contrary to popular belief, both high free cash flow and high dividend yields are rewarded by the equity market. High free cash flow stocks have outperformed by 5% p.a and high dividend yields by 9.1% since 2000. We expect both dividends and free cashflow to continue to grow in the future.

- Telecoms is cheap absolute and relative — On P/CE or EV/EBITDA, the sector has traded at 1 sd below mean since 1990. On a relative EV/EBITDA, it is at its cheapest ever. Better capital management, hence higher ROE, EPS and cash returns should push valuations up. The sector remains underowned by investors.

- Top telecom picks — We believe an optimal mix of growth and/or yield is available from Bharti, PT Telkom, SingTel, StarHub, LG Dacom and China Telecom. Among other Buy rated names, we view DiGi, PLDT and Globe as coming with the potential and the will to return surplus cash to shareholders. Korean and Chinese operators have the potential, but lack the will, in our view.

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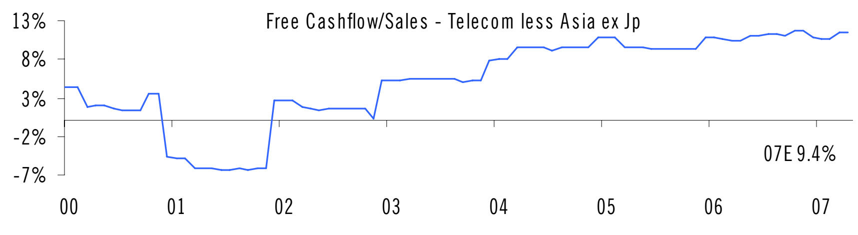
Asia ex Japan Telecom Free Cashflow/Sales Relative to Asia ex Japan



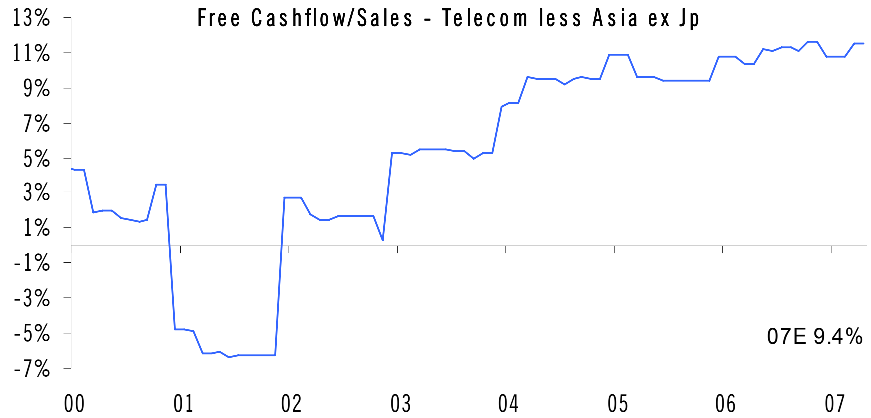
Source: Worldscope, Citigroup Investment Research

See Appendix A-1 for Analyst Certification and important disclosures.

[1]Citigroup Global Markets Asia

We have been overweight telecoms for a while now and have viewed the sector in two ways. First, for countries such as India, China and Indonesia we view their sectors as providing growth. The second basket we view as great surplus cashflow generators. Asian telecom stocks have outperformed as free cashflow generators for a while now, as evidenced by figure 1. Based on our 2007 forecasts, the free cash flow to sales ratio of the sector stands at 14.4%, a full 9% above the regional average. Unlike telecoms in Europe, the Asian telecoms were not lumbered with high 3G licence fee costs and hence balance sheets in Asia ex remained much healthier. The net effect of this has been that much more cashflow has found its way into the hands of the shareholders than into the hands of the bondholders. The reason this is so key is that, contrary to popular belief, both cashflow investing and dividend investing in Asia has worked a treat. In the case of free cashflow, investing the excess annual return of this strategy on an equal weighted basis would have been 5% since 2000 (figure 2). A strategy based on dividend yield would have done even better, outperfoming the region by 9.1% p.a. based on the same criteria as with the free cash flow analysis (figure 3).

Figure 1. Asia ex Japan Telecom Free Cashflow/Sales Relative to Asia ex Japan

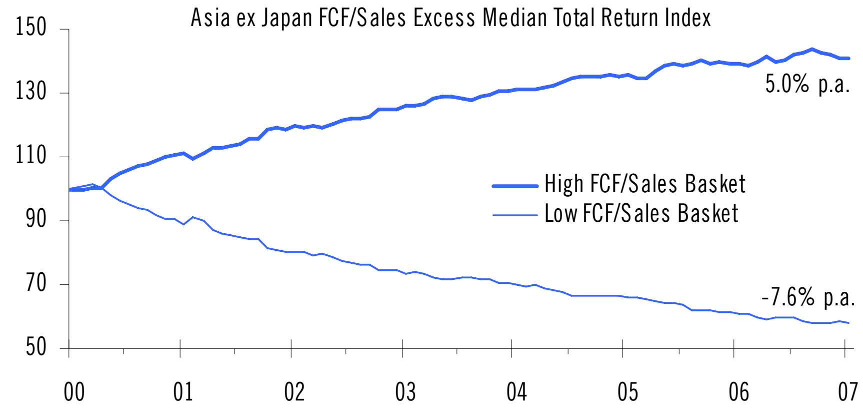


Source: Worldscope, Citigroup Investment Research

Why does dividend yield work better? Very simply, there are those which generate free cashflow but do not necessarily pay it out – free cashflow hoarders. Nice to have, but nicer if it is distributed to shareholders. Hence the dividend yield as a strategy tends to work much better.

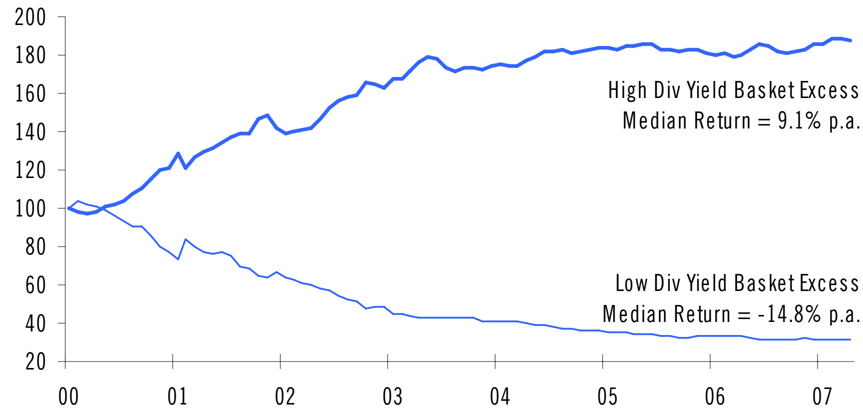
So far, the telecoms sector has been at the forefront of the special dividend/capital reduction theme. The reasons for this are three-fold. First, these companies are hugely free cash flow generative. Second, they are in mature businesses with high barriers to entry. Third, these companies are run by paid managers and not by families. Their incentive set is thus substantially different. For management to get paid come year-end, certain criteria need to be met, be it ROE, EPS growth or share price performance. Capital reductions help all three, special dividends more the latter. With family owned businesses, the focus on such matrixes just seems to be less. After all, the company is already yours. And as we are told – though are yet to experience ourselves – if you are already worth a few hundred million US dollars, what is an extra ten or twenty million. In other words, the incentive set is not as clear as with the hired hand.

Figure 2. Cashflow Investing Excess Annual Return on an Equal Weighted Basis is 5% Since 2000



Source: Worldscope, MSCI, Citigroup Investment Research

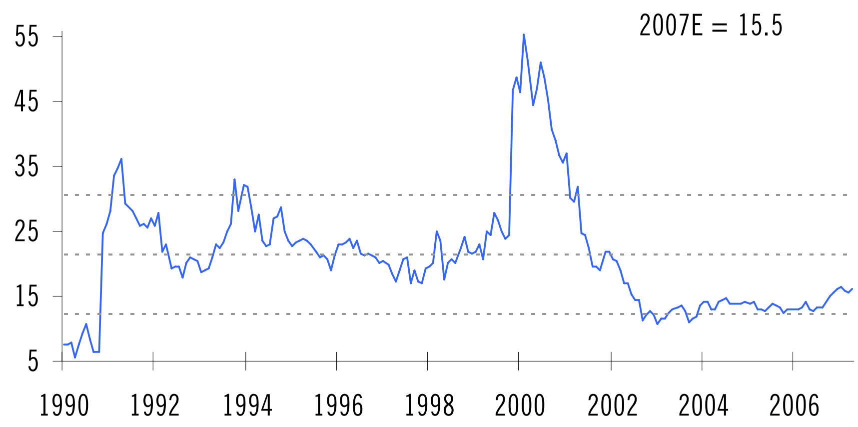
Figure 3. A Dividend Yield Strategy has Done Even Better, Outperfoming the Region by 9.1% p.a.



Source: Worldscope, MSCI, Citigroup Investment Research

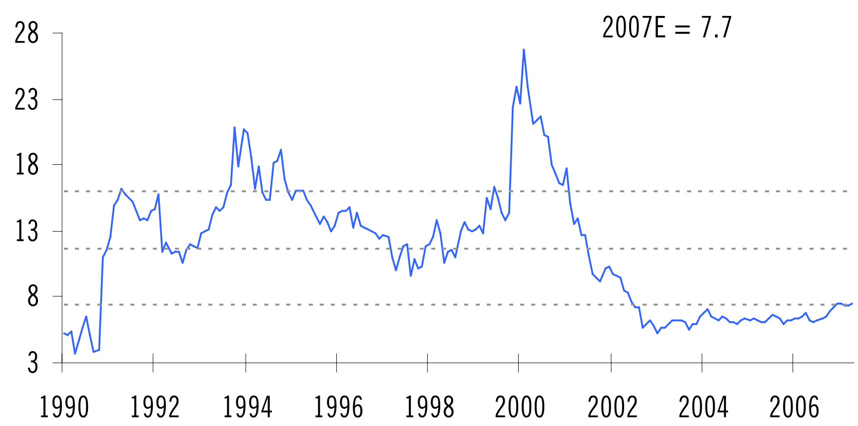
Valuations also speak in favour of the telecom sector. The charts below come from *the Asian Marco Investigator*, dated 2 May 2007. On both P/E and P/CE, valuations remain at the very bottom end of the range. On a P/CE basis, valuations are actually 1 sd below mean.

Figure 4. MSCI AC Asia Pacific ex Japan Telecom Trailing PE



Source: MSCI, IBES, Citigroup Investment Research

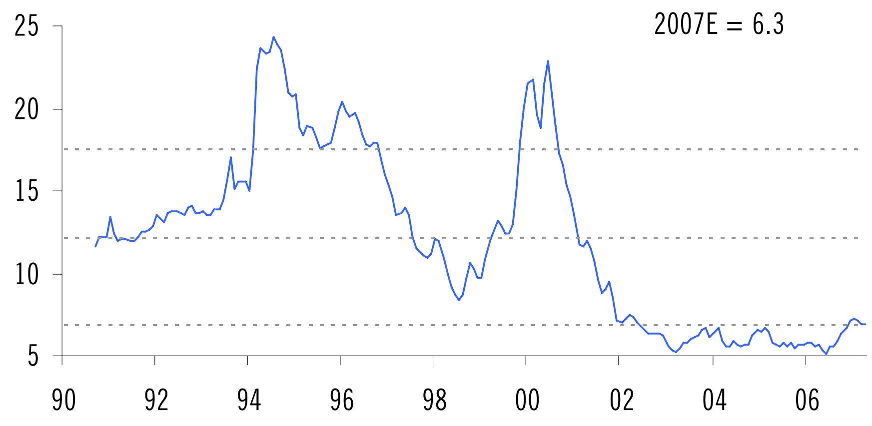
Figure 5. MSCI AC Asia Pacific ex Japan Telecom Trailing P/CE



Source: MSCI, IBES, Citigroup Investment Research

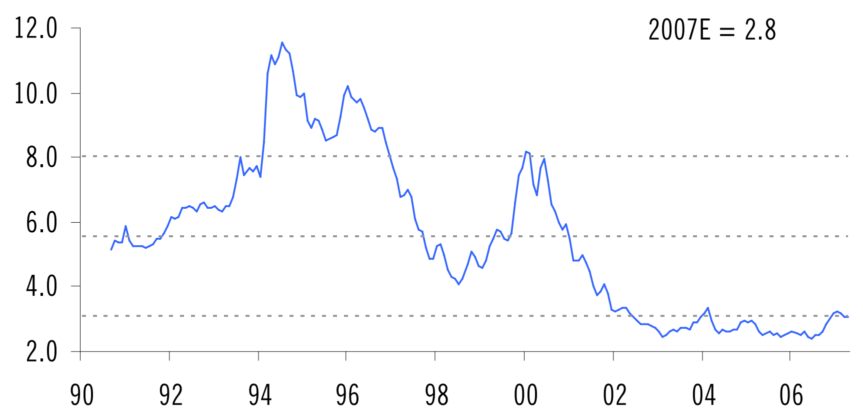
Turning to EV/EBITDA or EV/sales, again valuations are 1 sd below mean. On an absolute basis, this is a seriously de-rated sector. The catalyst to make it more expensive is the fact that this sector is and has the ability to return cash to shareholders.

Figure 6. MSCI AC Asia Pacific ex Japan Telecom Trailing EV/EBITDA



Source: FactSet, IBES, Citigroup Investment Research

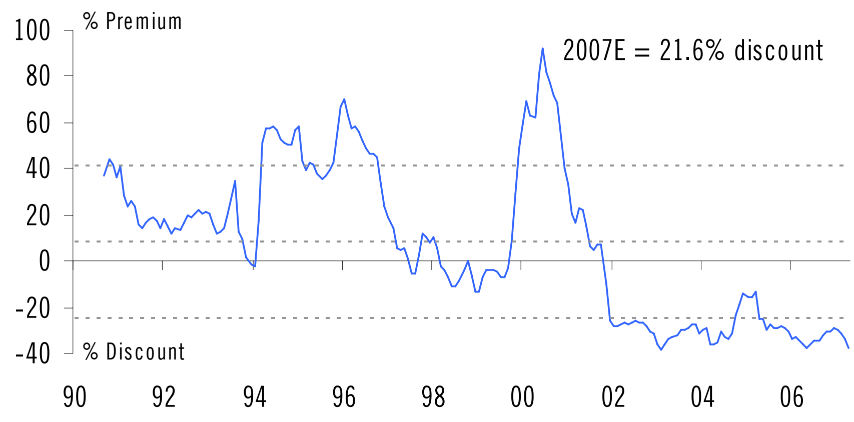
Figure 7. MSCI AC Asia Pacific ex Japan Telecom Trailing EV/Sales



Source: FactSet, IBES, Citigroup Investment Research

Relative to the region, the de-rating is clear to see. EV to EBITDA rel to the region is now at a 22% discount on a prospective basis, based on trailing we are 1 sd below mean.

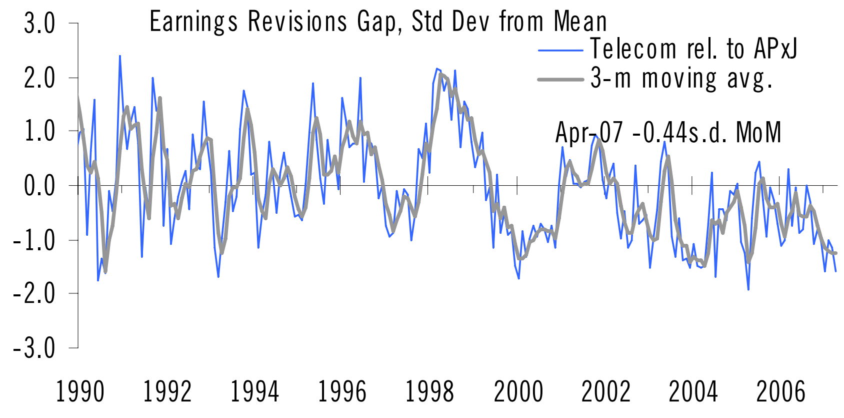
Figure 8. MSCI AC Asia Pacific ex Japan Telecom Trailing EV/EBITDA relative to the region



Source: Citigroup Investment Research

What has hurt the sector is relative earnings revisions. While the cyclicals and real estate sectors have had upward revisions to earnings, the telecoms have lagged since 2003. As the evidence of a US mid-cycle slowdown mounts, earnings revisions in more exposed sectors will turn negative. On a relative basis, telecoms will begin to look better. The added kicker is that capital reductions have a positive kicker on EPS forecasts. Relative earnings revisions are already at minus 2 sd below the mean, as bad as they have gotten historically.

Figure 9. MSCI AC Asia Pacific ex Japan Telecom Earnings Revisions Relative to APxJ



Source: IBES, Citigroup Investment Research

The reversal towards a more positive earnings trend will further help galvanize investor interest in the sector.

We continue to view the sector as a great place to invest. The sector is underowned. It has characteristics that lead to outperformance in its free cash flow and dividend yield, with both absolute and relative value and strong potentials for positive earnings surprises.

Below is a list of top picks by our analysts, sorted by expected price return.

Figure 10. Analysts' Top Telecoms Picks

Name	RIC code	Rating	Price (local curr.)	Expected Price Return	Div Yield 2007E	Expected Total Return
LG Dacom	015940.KS	1M	22550.0	33.0	2.7	35.8
Taiwan Mobile	3045.TW	1L	35.9	28.1	8.4*	36.5
China Comm Services	0552.HK	1M	4.8	27.5	1.5	29.0
Far Eastone	4904.TW	1L	39.1	20.4	13.0*	33.4
China Telecom	0728.HK	1L	3.9	21.8	2.6	24.4
PT Telkom	TLKM.JK	1L	9950.0	20.6	3.5	24.1
DiGi.Com	DSOM.KL	1L	21.2	17.9	6.1	24.0
True Corp	TRUE.BK	1H	7.3	23.3	0.0	23.3
China Unicom	0762.HK	1L	11.7	19.0	1.9	20.9
PLDT	TEL.PS	1L	2550.0	15.7	5.1	20.8
StarHub	STAR.SI	1L	2.9	14.6	5.2	19.8
SingTel	STEL.SI	1L	3.4	11.1	7.1	18.3
Bharti Airtel	BRTI.BO	1L	816.0	17.6	0.3	17.9
Chunghwa Telecom	2412.TW	1L	63.0	11.1	6.4	17.5
Globe Telecom	GLO.PS	1L	1290.0	12.4	4.9	17.3
Telekom Malaysia	TLMM.KL	1L	10.7	12.1	4.3	16.4
Shin Corp.	SHIN.BK	1H	29.0	6.9	8.2	15.1
Reliance Communications	RLCM.BO	1M	462.3	10.3	0.4	10.8

Source: Citigroup Investment Research estimates

*Include Capital Reduction

Appendix A-1

Analyst Certification

We, Chris W Leung, CFA, Markus Rosgen and Elaine Chu, research analysts and the authors of this report, hereby certify that all of the views expressed in this research report accurately reflect our personal views about any and all of the subject issuer(s) or securities. We also certify that no part of our compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.

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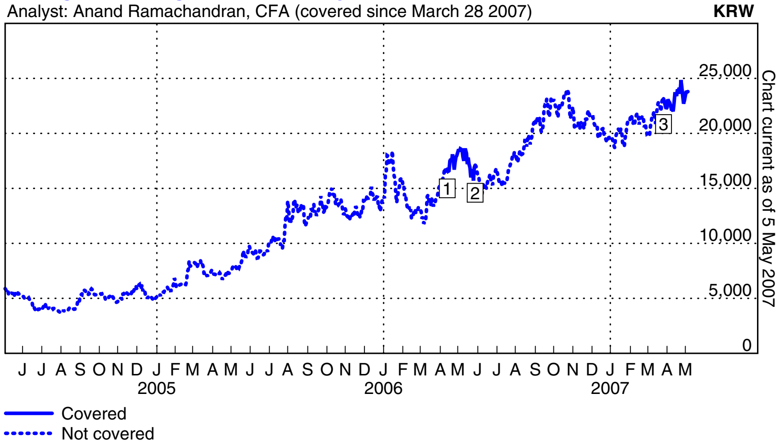
LG Dacom (015940.KS)

Ratings and Target Price History - Fundamental Research

Analyst: Anand Ramachandran, CFA (covered since March 28 2007)



#	Date	Rating	Target Price	Closing Price
1:	13 Apr 06	1M	20,000.00	16,750.00
2:	29 May 06	Coverage suspended		
3:	27 Mar 07	*1M	*30,000.00	23,150.00

*Indicates change.

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% of companies in each rating category that are investment banking clients	44%	46%	42%
India -- Asia Pacific (130)	58%	14%	28%
% of companies in each rating category that are investment banking clients	42%	50%	42%
Indonesia -- Asia Pacific (22)	50%	9%	41%
% of companies in each rating category that are investment banking clients	64%	100%	22%
Malaysia -- Asia Pacific (40)	68%	5%	28%
% of companies in each rating category that are investment banking clients	22%	0%	18%
Philippines -- Asia Pacific (2)	50%	50%	0%
% of companies in each rating category that are investment banking clients	0%	0%	0%
Singapore -- Asia Pacific (48)	50%	17%	33%
% of companies in each rating category that are investment banking clients	54%	25%	19%
South Korea -- Asia Pacific (75)	48%	27%	25%
% of companies in each rating category that are investment banking clients	14%	25%	5%
Taiwan -- Asia Pacific (91)	66%	20%	14%
% of companies in each rating category that are investment banking clients	17%	6%	23%
Thailand -- Asia Pacific (41)	49%	20%	32%
% of companies in each rating category that are investment banking clients	20%	25%	23%

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