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Wednesday, June 10, 2015

Telecommunication Sector

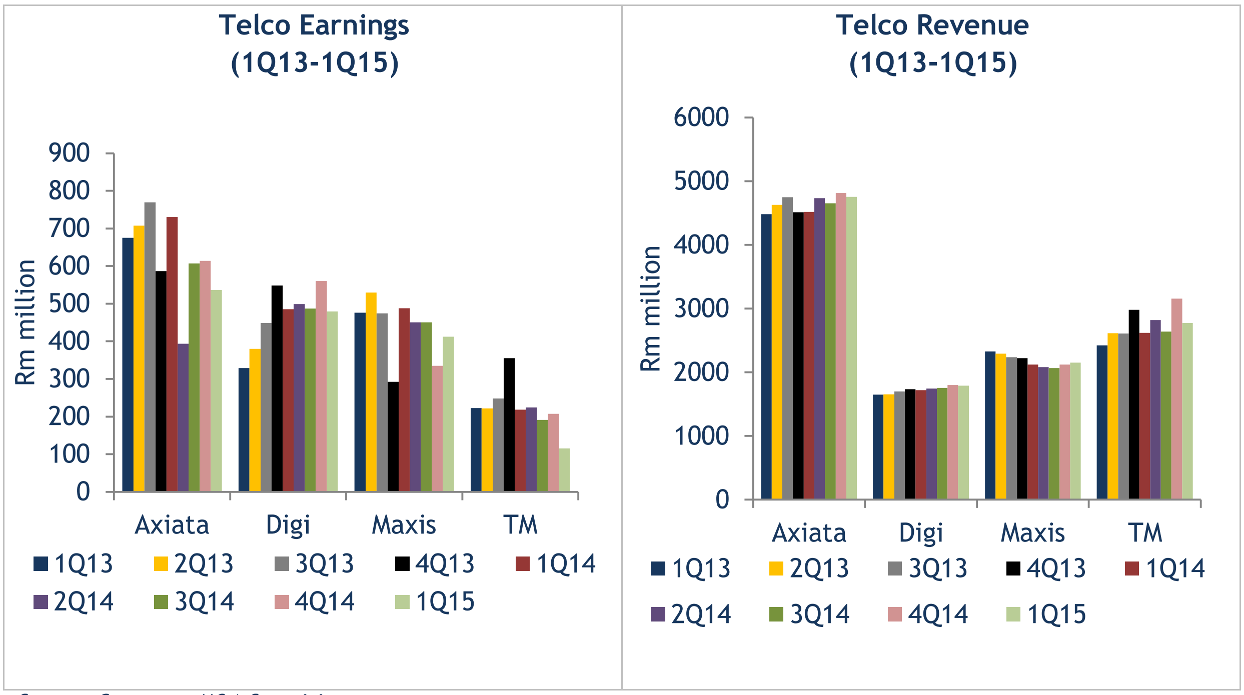
(Overweight)

"Rough Ride"

We maintain our Overweight call on telecommunication sector in view of i) stable dividend ii) steady net addition in both prepaid and postpaid segment and iii) potential wider margin on 4G's impact iv) goodies from Budget 2015, HSBB 2.0. Our top pick for telecommunication sector is Digi with a BUY call and TP of RM6.60 pegged at EV/EBITDA of 16.3x, a 15% premium against its last 3 years average.

Market Access

1Q15 results were mixed, TM the laggard. The recently concluded 1Q15 results seasons showed only two telcos earnings came in line with our full year net profit forecast with Digi and Maxis at 22.7% and 22.2% respectively. Meanwhile, Axiata missed marginally our forecast or at 19% and TM was the least performer at only 12.5%. Axiata weaker earnings were attributed largely to weaker performance by both XL and Celcom, while TM was dragged by its acquisition of loss making, P1 and higher operating costs. Notably, both Digi and Maxis reported steady services revenue with Maxis playing a catch-up game thanks to improving operating trends post-restructuring exercise, while Digi was hampered to some extent by higher marketing costs.



Source: Company, M&A Securities

Indicators show improving sign on the back of competition. Despite escalating competition in both prepaid and postpaid segment, the competitive landscape still had not imposed any adverse impact on profitability. However, telcos initiatives to grow direct and indirect cost were the reasons of weakening profitability albeit in slow pace. Direct and indirect cost relatively had a

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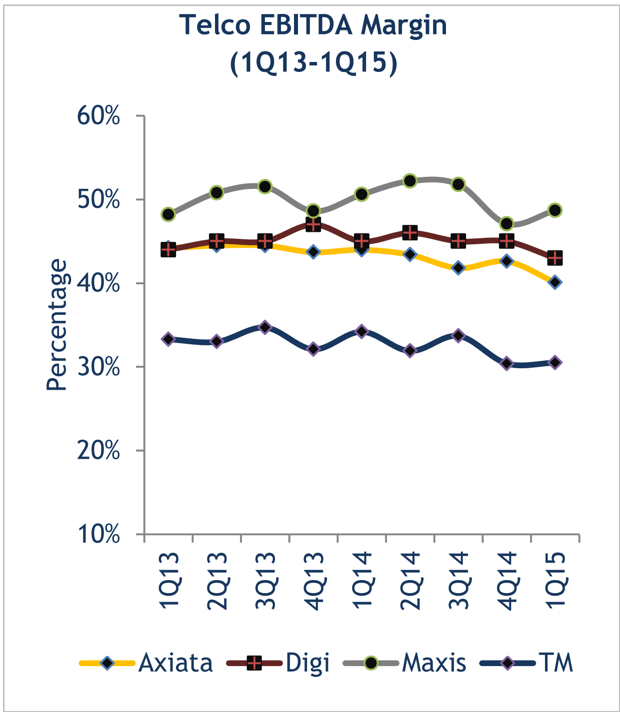
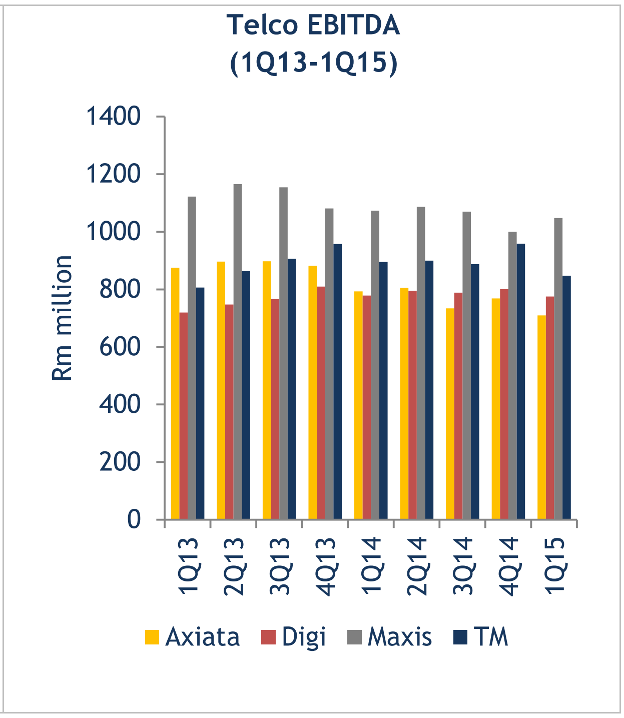
say on the profitability as telcos will capitalize it to acquire new subscribers. Nevertheless, despite costs trending up, but we consider it to be still under control and within management guidance.





Source: Company, M&A Securities

EBITDA margin under pressure from operating cost. Only Maxis and TM posted positive growth in EBITDA margin in 1Q15 on q-o-q basis. However, TM's EBITDA margin growth was boosted thanks to P1 revenue consolidation. On absolute term, TM EBITDA actually shed by 13.2% y-o-y in 1Q15 due to cost pressure. Maxis EBITDA had largely gained from improving cost discipline as all indirect expenses (except staff cost) fell. Digi EBITDA was still healthy despite rising cost from higher handset sales and marketing cost where it echoed the management stance to cap EBITDA margin at 45% level. Meanwhile, weaker contribution from Celcom and XL had dragged Axiata EBITDA margin to reach at only 40%, a level we have not seen since the past three years. Celcom was hit by IT issues which has been affecting marketing and distributing, as well as from recent flood in Malaysia East Coast. In the meantime, XL was hit by integration with Axis and business model change.

Battlefield in prepaid segment. Digi's strong net addition for the past quarters is now under threat with the comeback of Maxis. Maxis garnered strong net addition of prepaid subscriber for two consecutive quarters of 536k and 336 in 4Q14 and 1Q15 and on course to head on with its competitors due to product range that has been revamped, resulting in new product and pricing strategies. Nevertheless, Digi remained the clear winner in prepaid segment despite slow net addition in 4Q14 of 53k, no thanks to the beefing up in marketing cost, resulting in Digi to register a strong addition of 233k. Prolonged IT issue in Celcom has pushed the latter to lose 985k prepaid subscribers in the last 3 quarters with 1Q15 alone contributed 625k of net subscribers loss.

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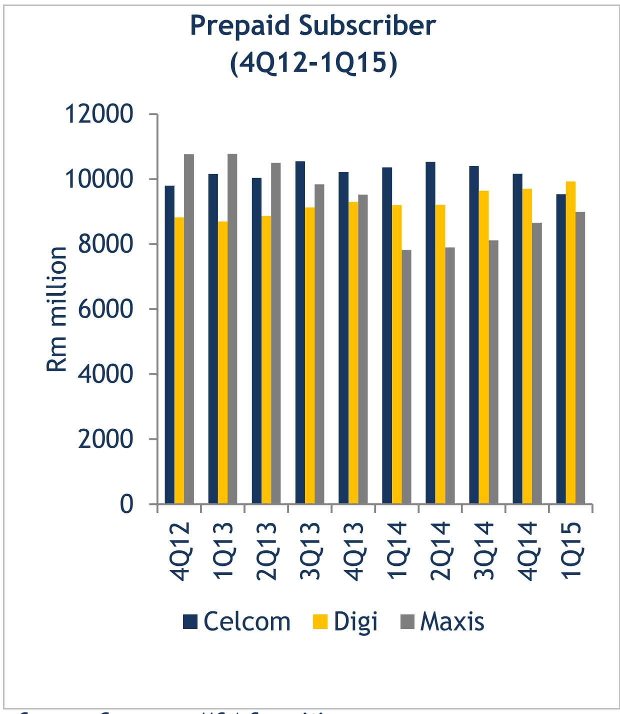
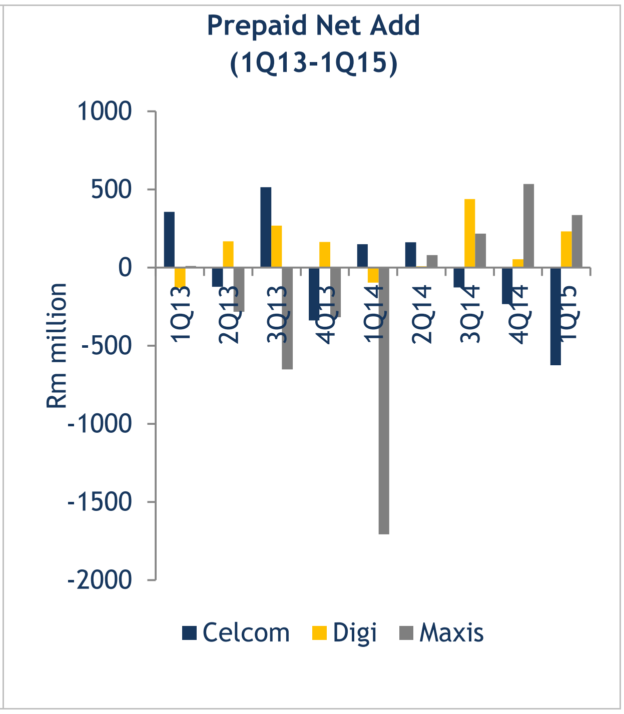
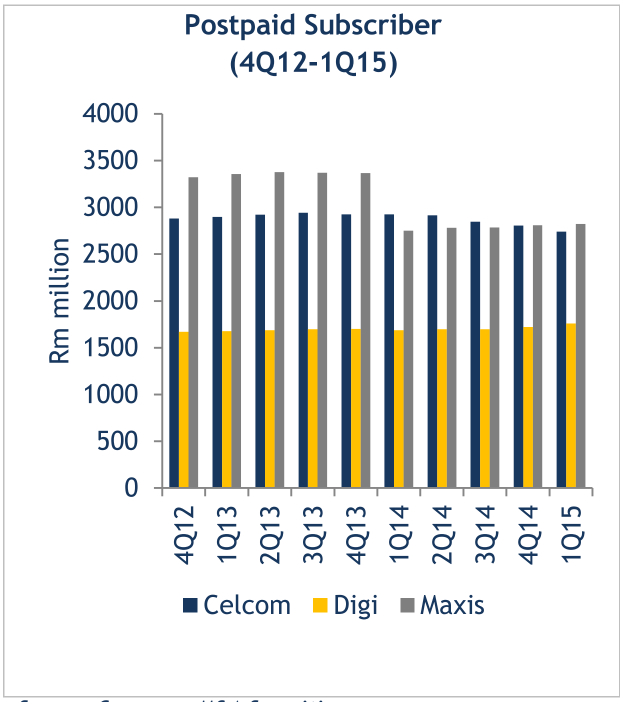
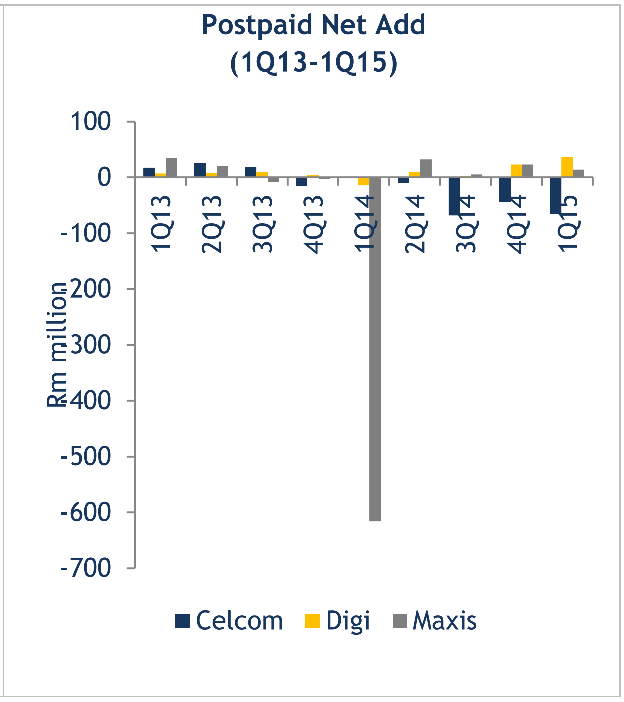




Source: Company, M&A Securities

Less competition in postpaid segment. Celcom's IT issues certainly cost its position in postpaid segment, where it lost its territory to Maxis pursuant to four consecutive quarters contraction in subscribers of 187k. Maxis eclipsed Celcom's leading position in postpaid segment since 4Q14 where Maxis strategies to revamp products and pricing strategies were fruitful. Nevertheless, Digi has been consistently adding subscriber in postpaid segment, but it is too far to be a threat to Maxis and Celcom positions.





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Data revenue, who is the winner. Maxis is no longer providing data revenue due to bundling packaging and hence, we are unable to provide in depth analysis. However based on available information, we foresee Maxis efforts as fruitful due to rising revenue generating subscriber (RGS) on q-o-q by 1.7% due to higher RGS in prepaid segment by 4.5% q-o-q. Digi is clearly a winner in growing data revenue due to their higher smartphone penetration of 53.2% as at 1Q15 on the back of bundled demand with higher mix from affluent and upper price range of smartphones. Meanwhile, the loss of subscriber for the past quarters has shaven Celcom's data revenue by 7% q-o-q.

Network modernization completed. As a whole, all telcos are nearing 90% of population coverage with network modernization at selected cities. Nevertheless, other telcos still trailing Maxis' LTE network with Maxis nearing 40% completion rate.

Should telcos spur high cost to lead? We feel that by dedicating large amount of cost and capex is not the best answer to rival competitor position as it may pressurised margins. Though the strategy may possibly grow the topline, however we are skeptical with the strategy in the long run as it may put a setback to margins. As we witnessed in 1Q15, several telcos expanded their indirect costs including Digi that grew their marketing expenses to stimulate the IPhone 6 sales. A similar situation had happened in Maxis where increasing sales and marketing expenses proved a setback to margins, coupled with forex losses. Contrary to Celcom, operating expenses skyrocketed by 380 bps to 59.8%, however we understand this was one-off due to higher cost relating to customer projects. TM continued to be plagued by higher cost despite management stance to keep it lower. Nevertheless, we understand the P1 acquisition had dragged the TM's cost.

Brief Outlook

a. **Axiata.** We have faith in Axiata's approach to turn around Celcom, though it is making slow progress on the transformation. Majority of the hurdles are behind now and it is expecting gradual improvements ahead. Its IT issues are now near completion with 1-2 month timeline to prepare the system ready. The acceptance of postpaid plan seems encouraging and will introduce new prepaid plan soon.

b. **Digi.** Despite marginally weaker results in 1Q15, but it is purely due to shorter working days that hampered the development and rising costs due to smartphone bundled offerings. Despite strong net addition, prepaid and postpaid ARPU slipped to RM81 and RM39 (4Q14: RM83 and RM41) respectively due to steeper decline in voice revenue amid intensified competition and MTR revision.

c. **Maxis.** On the whole, the 1Q15 results reaffirm the positive transformational changes that are taking place. We are nevertheless of the view that any sharp earnings upgrade in the near term would likely be challenging considering that the other incumbent operators are pursuing similar strategies to grow revenue. Maxis sexiness on dividend policy has waned due to changes in its dividend payout policy that potentially shave its yield to below 4%.

Intensified competition with new players. At this stage, TM is still unable to offer hints on its plan on P1 that could potentially put a heat to competitors. Nevertheless U Mobile aggressive marketing strategy is starting to bite competitors' market share through its aggressive pricing strategy. We do expect telcos to react to U Mobile aggressive pricing later this year should U Mobile consistently register impressive net addition.

Recommendation. Despite the headwinds in GST implementation, we maintain our **Overweight** call on telecommunication sector. We note that valuation offer by telcos are not cheap, however in view of solid dividend payment in current negative environment may offset the lofty valuation. Attractions on the sector include 1) attractive dividend stream 2) strong broadband initiatives and take up rate and 3) steady postpaid and prepaid net addition. **Digi** is our top pick with a TP of RM6.60 pegged at EV/EBITDA of 16.3x, a 15% premium against its last 3-year average. Digi is a BUY.

Table 1: Capex Guidance

FY14 Capex				FY15 Capex
(Million)	Guidance	Spent	Details	
Axiata	RM4.4 bil	RM4.0 bil	Network modernization, IT Initiatives	RM3.85 bil
Maxis	RM1.1 bil	RM1.14 bil	Network modernisation and improvement in customer experience.	RM900 mil
Digi	RM900 mil	RM904	Modernize network equipment	RM750 mil
Telekom	18% of revenue	RM946 mil	Refreshed CDMA with LTE over 850MHz under TMgo, launch 280 sites nationwide by year end.	20% of revenue

Source: Company: M&A Securities

Table 2: Peers Comparison

Company	FYE	Price (RM)	EPS (RM)		P/E (x)		P/B (x)		ROE (%)	Div Yield (%)	TP	Call
			FY15	FY16	FY15	FY16	FY15	FY16				
Axiata	Dec	6.32	0.31	0.34	23	21	2.8	2.8	11.6	3.1	7.40	Hold
Maxis	Dec	6.82	0.27	0.28	27	25	12.0	12.6	32.1	4.5	7.10	Hold
Digi	Dec	5.73	0.27	0.28	23	22	65.3	62.1	301.5	4.2	6.60	Hold
Telekom	Dec	6.90	0.27	0.29	27	25	3.4	3.4	11.3	3.6	6.87	Hold
Time DotCom	Dec	6.68	0.28	0.32	21	18	1.3	1.2	8.0	1.0	NR	NR
Average			0.28	0.30	24	22	17.0	16.4	72.9	3.28		

Source: Bloomberg, M&A Securities

Market Access

M&A Securities

STOCK RECOMMENDATIONS

BUY	*Share price is expected to be ≥+10% over the next 12 months.*
TRADING BUY	*Share price is expected to be ≥+10% within 3-months due to positive newsflow.*
HOLD	*Share price is expected to be between -10% and +10% over the next 12 months.*
SELL	*Share price is expected to be ≥-10% over the next 12 months.*

SECTOR RECOMMENDATIONS

OVERWEIGHT	*The sector is expected to outperform the FBM KLCI over the next 12 months.*
NEUTRAL	*The sector is expected to perform in line with the FBM KLCI over the next 12 months.*
UNDERWEIGHT	*The sector is expected to underperform the FBM KLCI over the next 12 months.*

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