

BACKGROUND :

PCCW is spinning off its telecommunications business into HKT Trust, the first trust structure to be listed in Hong Kong. The trust sells so-called share-stapled units to investors that will include a unit in HKT Trust, a beneficial interest in one common share of HKT Limited that is linked to the unit and a preference share in HKT Limited that is also stapled to the unit. It should be noted that investors typically buy trusts for their yields rather than potential unit price increases.

The specific businesses being spun off will include the fixed-line, broadband and mobile telecommunications operations, where as the incumbent player in the industry, it has a dominant position. In local telephony and data/broadband services for example, the company has a 61.2% market share with 2.63 million exchange lines in service and 65.4% market share with 1.44 million broadband access lines, respectively. Its broadband service coverage also reaches 98% of Hong Kong households. In the more crowded mobile telecom space, its 1.51 million subscribers give it a 12.1% market share.

Subscription deadline is set for November 21. Shares will be priced on November 22 and will resume trading on November 29.

COMMENTS :

The objective of the offering is to raise capital to pare down 7.8 billion HKD in debt, with the balance repatriated to PCCW. The company currently has a fairly highly levered balance sheet, with a D/E ratio of 174.12%, a net D/E ratio of 148.09% and EBITDA to interest coverage ratio of 5.59x. As PCCW owns 100% of the trustee-manager, which in turn retains full control of the underlying businesses, we think it's convenient to use the appeal of dividend yields in a volatile market context to raise cheap capital, all without ceding any control.

Units are expected to be offered between the price range of 4.53 and 5.38 HKD. While PCCW has high brand recognition in Hong Kong, we expect demand to be tepid with upcoming IPO of Chow Tai Fook. Therefore, we think the final price will be at the midpoint of 4.96 HKD. With approximately 2.05 billion shares offered, 10% of which is allocated for Hong Kong retail investors, we are looking at total amount raised of 10.17 billion HKD and implied market capitalization of 31.79 billion HKD (assuming the over-allotment option is not exercised). Under such a scenario, PCCW will retain ownership of 68% of the new entity.

Hong Kong is a highly saturated market marked by CAGR of just 1.8% in exchange lines and IP telephony services, 5.2% in broadband internet access customer accounts and 7.5% in mobile subscribers in the past 3 years. The company is not likely to gain incremental momentum in the highly competitive mobile telecom space as the other four operators combine for a 87.9% market share. Future growth is likely to come only from its traditional strong suits of fixed-line and broadband and be marginal in nature due to steadily declining ARPU.

At a 4.53 HKD subscription price, annualized yield is expected to be 8.11% in 2011 and 8.86% in 2012. Annualized yield is expected to be 6.82% in 2011 and 7.46% in 2012 at 5.38 HKD. Due to the stable nature of company cash flows, we believe the targets are reasonable and achievable. The yield, at 5.38 HKD, is also in line with similar-sized trust CapitaCommercial from Singapore, with projected yield of 6.83% for 2011 based on current market price. While the yield is more attractive at 4.53 HKD, the HKT Trust unit price is still expensive on P/E terms compared to local competitors such as Hutchison Telecommunications. HKT Trust has a P/E of 27x based on projected 2011 numbers, versus an industry average of just 14.7x.

While there is certainly no present need for alarm, we view potential impairments to goodwill as the single biggest risk going forward. Goodwill presently represents 53.7% of total assets and it would be interesting to see how it holds up in a competitive space marked by a critical need to stay ahead of the technology curve.

November 18, 2011

Initiation : Neutral

Research Department

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Stock Data

Maximum Offer Price	5.38 HKD
No. of Share-Stapled Units	2,053.35 M
Implied Market Cap.	11.05 B
Subscription Deadline	11/21/11

FINANCIALS :

Operating Drivers	Year ended December 31			Half-year ended June 30	
	2008	2009	2010	1H10	1H11
Telecommunications services					
<i>Local telephony services</i>					
Exchange lines in service (K)	2,603	2,588	2,590	2,587	2,625
Business lines	1,195	1,182	1,183	1,180	1,217
Residential lines	1,408	1,406	1,407	1,407	1,408
Blended ARPU (HKD)	119	111	101	103	96
<i>Local data & broadband services</i>					
Total broadband access lines (K)	1,302	1,297	1,367	1,298	1,437
Retail consumer broadband subscribers	1,126	1,146	1,215	1,148	1,285
Retail business broadband subscribers	113	114	115	114	116
Blended ARPU (HKD)	245	249	266	272	260
<i>Traditional data capacity in service (Exit Gbps)</i>	927	837	1,045	953	1,243
<i>International telecommunications services</i>					
Retail IDD minutes (M mins)	878	710	652	674	618
International private leased circuit bandwidth (Exit Mbps)	78,202	82,913	109,864	88,108	148,834
Mobile					
Mobile subscribers (K)	1,313	1,422	1,484	1,469	1,506
3G post-paid	414	529	667	606	880
2G post-paid	440	376	250	319	43
2G pre-paid	459	517	567	544	583
Blended post-paid ARPU (HKD)	151	143	141	138	153
3G post-paid ARPU	206	189	175	175	163
2G post-paid ARPU	113	89	76	78	101

Calculation of Distributions HKD M	Year ended December 31			Half-year ended June 30	
	2008	2009	2010	1H10	1H11
Turnover	7,201	17,947	18,527	9,206	9,537
Cost of sales	(2,306)	(6,642)	(7,451)	(3,635)	(3,758)
General & administrative expenses	(4,309)	(7,981)	(8,131)	(4,171)	(4,287)
Other gains/(losses), net	63	-	40	-	(28)
Losses on property, plant & equipment	-	(25)	-	-	-
Finance costs, net	(240)	(1,468)	(1,562)	(793)	(733)
Share of results of jointly controlled companies	-	-	(73)	(5)	(5)
Profit before income tax	409	1,831	1,350	602	726
Income tax	(132)	(480)	(378)	(180)	(168)
Profit for the year/period	277	1,351	972	422	558
Attributable to:					
Holders of share stapled units	274	1,316	925	400	537
Non-controlling interests	3	35	47	22	21
Profit for the year/period	277	1,351	972	422	558
Income tax	132	480	378	180	168
Profit before income tax	409	1,831	1,350	602	726
Loss/(gain) on disposal of PP&E, net	17	3	(14)	1	(1)
Depreciation & amortization	2,201	3,936	4,318	2,122	2,132
Other (gains)/losses, net	(63)	-	(40)	-	28
Losses on property, plant and equipment	-	25	-	-	-
Finance costs, net	240	1,468	1,562	793	733
Share of results of jointly controlled companies	-	-	73	5	5
EBITDA	2,804	7,263	7,249	3,523	3,623
	<i>38.94%</i>	<i>40.47%</i>	<i>39.13%</i>	<i>38.27%</i>	<i>37.99%</i>
EBITDA	2,804	7,263	7,249	3,523	3,623
Customer acquisition costs & license fees	(179)	(907)	(1,058)	(365)	(613)
Capital expenditures	(2,254)	(1,450)	(1,564)	(623)	(721)
Tax payment	-	(24)	(43)	(24)	(24)
Finance costs paid	(237)	-	(302)	(227)	-
Interest expense paid	(219)	(1,432)	(1,296)	(661)	(678)
Interest income received	2	7	9	2	18
Changes in working capital	1,417	(1,006)	(976)	(402)	(253)
Adjusted funds flow for the year/period	1,334	2,451	2,019	1,223	1,352

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