China Mobile Limited (CHL): Sell Recommendation

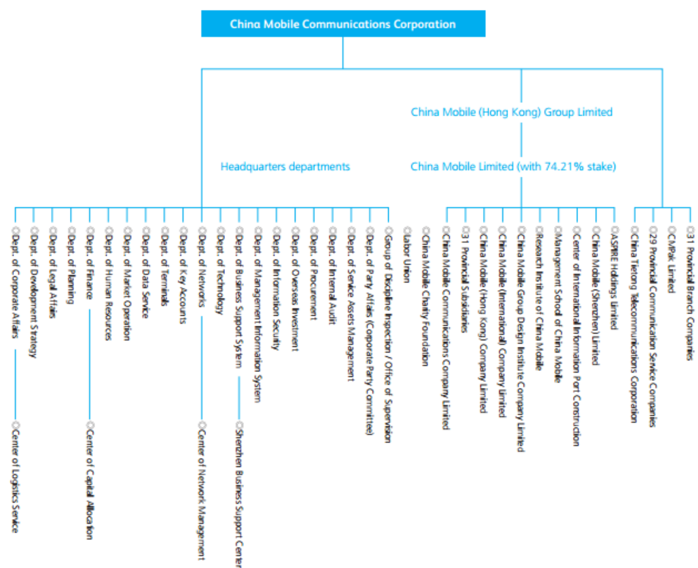
For several years China has been seen as a land of opportunity for investors who quote its GDP growth, economic policy reform and vast, undeveloped markets as some of the many reasons for including exposure to China in its portfolios. For conservative investors who are not comfortable investing internationally and managing currency risk, American Depository Receipts (ADRs) are a way to gain exposure to China without sacrificing the familiarity of American exchanges and currency. However, investors must be aware that they are investing in a foreign company operating under different regulatory and economic environments. Investors should not let themselves get caught up in the hype without first investigating the company and business environment they are investing in. As our case study of ADR China Mobile Limited (CHL) will seek to demonstrate, great top line growth does not necessarily translate into great returns for investors.

I. Overview

The Chinese telecom industry is in a phase of rapid development. According to China Mobile, the penetration rate is only 50%. Of the captured market CHL is 62%, dwarfing its two competitors, China Telecom and China Unicom, combined. Within the growth of the mobile phone market China is seeing a second revolution: the shift from 2G to 3G/4G. These two sources of expansion, new user subscriptions and conversion of existing 2G users to 3G/4G (and reaping the mobile data revenues), promise years of continued, double digit growth. China Mobile, boasting the largest 3G/4G network and the largest customer base (of which 68% is 2G), is positioned perfectly to ride these dual tailwinds through years of high revenue growth. With this kind of story, it is hard to imagine why we would write a sell recommendation on CHL.

II. Holding Company Issues

As we previously warned, investors must be aware of the regulatory environment of the company they are investing in. In China, the government's political economy necessitates control over the state apparatus through control over the strategically important sectors, which were defined in 2006 as armaments, power generation and distribution, oil and petrochemicals, telecommunications, coal, aviation and shipping industries. Accordingly, China Mobile is majority owned (74%) by China Mobile Communications Corporation (CMCC), a state owned telecommunications company, through a wholly owned subsidiary.



(Source: China Mobile 2013 10-K)

Looking through CHL's 10-K yields two sections on pages 10 and 35 titled "We are controlled by CMCC, which may not always act in our best interest" and "Our Operating Arrangements with CMCC Have Affected and May Continue to Affect Our Financial Results," respectively. On page F-67 section 36(a), "Transactions with CMCC Group," gives a complete summary of CHL's business with its parent company:

(a) Transactions with CMCC Group

The following is a summary of principal related party transactions entered into by the Group with CMCC and its subsidiaries ("CMCC Group"), for the years ended December 31, 2011, 2012, and 2013.

	Note	2013 Million	2012 Million	2011 Million
Telecommunications services revenue	(i)	1,590	2,113	1,709
Telecommunications services charges	(i)	2,843	1,580	1,138
Property leasing and management services charges	(ii)	808	785	776
Interest expenses	(iii)	103	161	219
Interconnection revenue	(iv)	241	253	279
Interconnection charges	(iv)	500	472	446
Network assets leasing revenue	(iv)	109	109	47
Network assets leasing charges	(iv)	9,837	2,950	328
Network capacity leasing charges	(v)	3,876	2,477	1,092
Revenue derived from cooperation of telecommunications services	(vi)	494	341	177
Charges for cooperation of telecommunications services	(vi)	2,232	1,936	1,154

(Source: China Mobile 2013 10-K)

Some quick calculations will show that net expenses paid by China Mobile to CMCC increased 135% from 2012 to 2013. While revenues grew 8.3% from 2012 to 2013, operating expenses grew 15.2%, in no small part due to uneconomic business activity with CMCC. The bottom line for regular investors? A 5.9% drop in in profit attributable to equity shareholders, part of a consistent trend of falling net income margin. In 2008, that profit margin was 27.3%. In 2013 it was 19.3%. While being a SOE is advantageous to the company, entailing perks like subsidies and advantageous regulation, it can also be limiting for shareholders, who are placated with enchanting stories about top line growth only to see that revenue growth dissipate into parent company pockets as operating expenses. It will never trickle down.

III. But What About SOE Reform?

As a side effect of special treatment and protection by the government, SOEs are inefficient, lack innovation and, generally, are unprofitable (this is not the case with China Mobile). Concerned with the state of its SOEs, China has pledged reform to encourage competitiveness and cost-efficiency in some of these enterprises. Most notably, this includes a pilot program including six large SOEs for mixed ownership reform as part of a larger landmark blueprint for economic reform announced late 2013. Many investors argue that SOE reform will open the floodgates and finally allow shareholders to enjoy the growth that has taunted them from the top line for so long. We are skeptical that meaningful reform will reach China Mobile any time soon. First, China Mobile is the largest player in a strategically important sector. It is unfathomable that the Chinese government would relinquish control over its citizens' communication and media network. Second, China Mobile's own executives oppose reform. According to a September 4th article in Bloomberg Businessweek, SOEs, including China Mobile, have pushed back hard against economic reforms, arguing that state companies have already increased profitability and that state companies are "critical to maintaining government dominance" in the face of increasingly hostile neighbors. It is not difficult to imagine why executives are less than willing to trade their cushy position in when the outcome will require them to streamline their companies, cut excess costs and compete in a truly competitive market.

Since 2008 various agencies of the Chinese government have encouraged the formation and development of the three competitive and stand-alone telecommunications service providers (China Mobile, China Telecom and China Unicom, all SOEs). More recently it has noticed the overwhelmingly lopsided success of this program as China Mobile has grown far faster than its competitors. The PRC has announced that it will extend favorable regulatory policies to the latter two companies, which so far has included limiting the extent to which China Mobile can advertise its products and services. Though it is unclear what policies will be implemented in the future, the agencies' intentions to increase competition will likely result in China Telecom and China Unicom capturing some of the future growth that investors planned would be attributable to China Mobile.

The Bottom Line

We place a sell recommendation on CHL because we believe investors are focused on the China success story and the Company's impressive revenue growth while ignoring inefficient, ongoing business practices with its holding company and declining margin of its profit attributable to equity holders. Since we do not believe China is ready to relinquish control of its telecommunications industry, as the government itself has said it is not, we forecast continuing declines in profit margins and diminished share value.