

Can The Biggest Mobile Market Grow Even Bigger?

China Mobile (941.HK) first caught my eye when I was studying telco balance sheets. To my horror, I found that many developed world telcos had been financial re-engineered i.e. their utility-like characteristics had tempted them to take on enormous debt loads. For example, Swisscom, previously exemplary for its prudence in not participating in the disastrous European 3G auctions of 2000 and until 2005, boasted a net cash balance sheet, is now buried under a net debt equity ratio of 138%!

In contrast, Asian telcos had much lower gearing despite much faster organic growth rates. Even so, China Mobile stood out because it had an enormous pile of cash – nearly 60% of its book value was cash!

But most research reports I read assumed that China's telco market was ex-growth and chorused that the incremental customers were generating less revenue per customer – in industry parlance, falling ARPU or Average Revenue Per User.

Here's a different angle.

	China	United States
Population	1.35 billion	310 million
GDP per Capita (US\$)	4,000	48,000
Mobile penetration	60+%	90+%
Telco industry revenue**	US\$125 billion	US\$300 billion
Telco revenue per Capita (US\$)	US\$93	US\$968
<i>** proxied by combined 12 month trailing revenue of China Mobile, China Telecom and China Unicom (for China) and Verizon, AT&T, Sprint, T-Mobile USA, MetroPCS and US Cellular (for United States)</i>		

What I find interesting is that the telco industry revenue per capita in the US is about 10x that of China while the GDP per Capita is 12x. One can easily see that if penetration rates in China were as high as the United States, the two ratios would be a lot similar especially since many of China's potential new subscribers are low ARPU customers out in remote rural areas.

China's GDP per capita has doubled in the past 4-5 years. If it were to do so again in the next 5 years, by 2015, China's GDP per capita would be \$8,000. The telco industry in China is still adding north of 6 million subscribers per month. If this pace is sustained, it is also likely that by 2015, mobile penetration in China would also be close to 90%.

If the relationship between GDP per capita and telco industry revenue per capita continues to hold, China's telco industry revenue could be over US\$350 billion by 2015.

If market shares remain the same, then China Mobile's revenue has the potential to grow to over US\$200 billion from its current US\$70 billion.

I don't know what will happen to profitability as I am not a telco analyst and I don't know the dynamics of the Chinese market.

Nevertheless, as China Mobile now makes about US\$16 billion in annual profit, it is a rather exciting thought to imagine that it's profitability could exceed US\$40 billion by 2015, possibly making it one of the most profitable companies on earth!

Another interesting possibility would be a change in China Mobile's balance sheet. Here is a comparison of the net debt-equity ratio and revenue of some telcos.

Telco	Net Debt to Equity Ratio	Trailing 12 months revenue (US\$ billion)	Telco	Net Debt to Equity Ratio	Trailing 12 months revenue (US\$ billion)
China Mobile*	-52%	68.7	Verizon	62%	108.0
China Telecom	27%	31.4	AT&T	66%	123.2
China Unicom	34%	23.4	Sprint	97%	32.0
Singtel	20%	12.3	T-Mobile USA	43%	21.4
Swisscom	138%	11.3	MetroPCS	106%	3.8
Deutsche Telecom	108%	88.8	US Cellular	14%	4.2
Vodafone	39%	71.0			

*China Mobile is net cash to the tune of 52% of its shareholders' equity

If China Mobile were to reengineer itself financially to attain a still conservative 20% net debt to equity ratio, it can potentially release almost HK\$22 per share in cash dividends, or more than a quarter of the current share price.

So, we now have a rather strange situation where industry observers who feel that a company with the potential to pay out over 25% of its share price in dividends whilst facing a market that could grow by 150% (in US\$ terms) over the next 5 years is *ex-growth*!

I have two comments about falling ARPUs.

1. If the incremental ARPU, low as it is, is still significantly profitable compared to the cost of acquiring the incremental subscriber, then the market remains earnings accretive. Why then should we allow the falling average to dominate our thoughts?
2. China's next economic development plan (2011-2015) is likely to pay a lot of attention to rural wealth and incomes. Therefore, these low ARPU subscribers from rural areas will not remain low for long.

Anyway, my point is simply that the China telco market is a very long way from being *ex-growth*.

