

A PUBLICATION OF
RIEDEL RESEARCH
GROUP

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CHINA INVESTMENT OPPORTUNITIES

Objective Insights for Winning in China's Growth Markets

This Month: China's Telecommunications Market

ON THE COVER

MARKET COMMENTARY

INSIDE

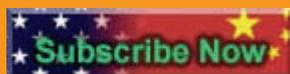
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MARKET COMMENTARY

China News

Asia continues to be *the* place to invest in the second-half of 2005. All of China and Hong Kong's stock markets rallied in November, as reduced concerns of interest-rate hikes, strength in world markets, a resolution of U.S. and China's textile trade tensions, and falling oil prices over-rode any looming fears of the Asian bird flu.

President Bush visited China in mid-November. His main concerns were tackling China's approximate \$200B trade surplus with the U.S., widening the range at which China's currency can trade, and protecting U.S. companies' intellectual property rights.

The Chinese government is now directing its attention towards stimulating domestic consumption versus increasing exports to drive its economy. Measures aimed at raising consumer spending are sure to translate into increased earnings for China's domestic companies and sustained growth in their economy. Over time, we expect this growth to be driven primarily by consumer spending, as incomes rise and financial products such as credit cards become more readily available.

The China Investment Opportunities newsletter will continue to highlight companies benefiting from these trends.

Market News

The Hong Kong Hang Seng Index was up 4% in November and 5% year-to-date (YTD). The Shanghai B- share index is up a strong 21% YTD, and the Shenzhen B- share index is up 10% YTD. Lastly, the Bank of New York China ADR Index is up 18% YTD. Capital inflows ahead of a possible currency revaluation, robust year-end retail-sales season, and growth in domestic consumption should maintain this strength through the end of '05.

China Construction Bank (CCB) raised \$8B in its IPO in late-October, becoming the world's largest IPO in the past four years. CCB is the first of China's big four lenders to go public, with the other three set to follow suit over the next two years. CCB is up 6% since its IPO.

Shares of Yanzhou Coal were down in November from disappointing quarter results. After a 5-year run-up, coal prices in China have begun to fall, but dropping temperatures this winter are expected to hold prices stable.

Aluminum Corporation of China's shares were also up in November. Chalco is China's largest aluminum producer by output and the country's only producer of alumina, the key raw ingredient in aluminum. As China's economy expands, we expect shares of this company to outperform.

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Industry Report: Telecom

The Chinese government established China Unicom in 1994 to liberalize the telecom industry and transition away from the government-run monopoly of the industry.

In 1999 China Telecom was split into three parts- fixed lines, mobile and satellite. China Mobile and China Satcom were created to run the mobile and satellite sectors, respectively, while China Telecom continued to be a monopoly provider of fixed line services.

The second restructuring in 2002 split China Telecom geographically in North and South.

China Netcom was formed with 30% of the resources of China Telecom, serving the

Northern region. Thus in the last decade, the Chinese telecom industry has changed from a state run monopolistic structure to a state run oligopolistic structure.



FIXED LINE SERVICES

China owns the world's largest fixed line and mobile networks in terms of network capacity and number of subscribers.

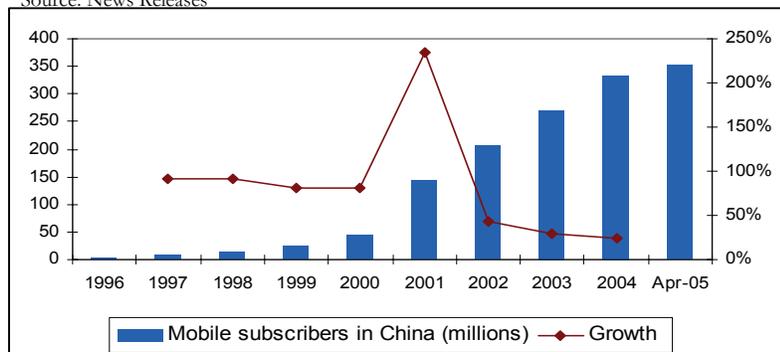
China has seen healthy growth in its fixed line subscribers from 140 million subscribers in 2000 to 329.5 million subscribers at the end of 2004, a

CAGR of 23%. The Ministry of Information Industry estimates fixed line subscribers will grow by 15% to reach 360 million at the end of 2005.

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Source: News Releases



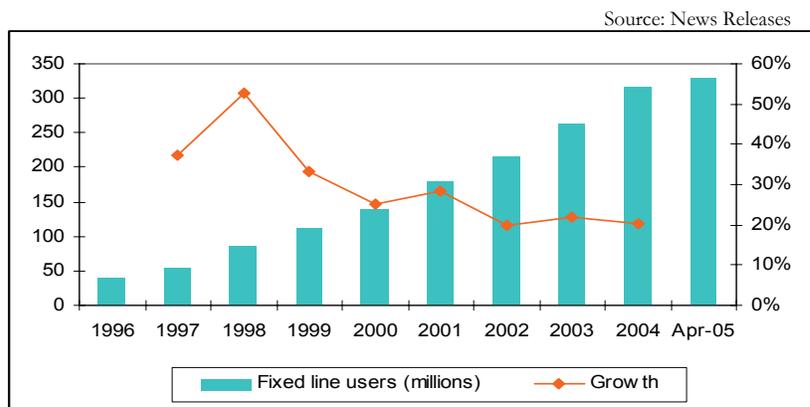
MOBILE USERS IN CHINA

China surpassed the United States in 2002 to become the world's largest mobile market, overtaking the Chinese fixed line market in October 2003.

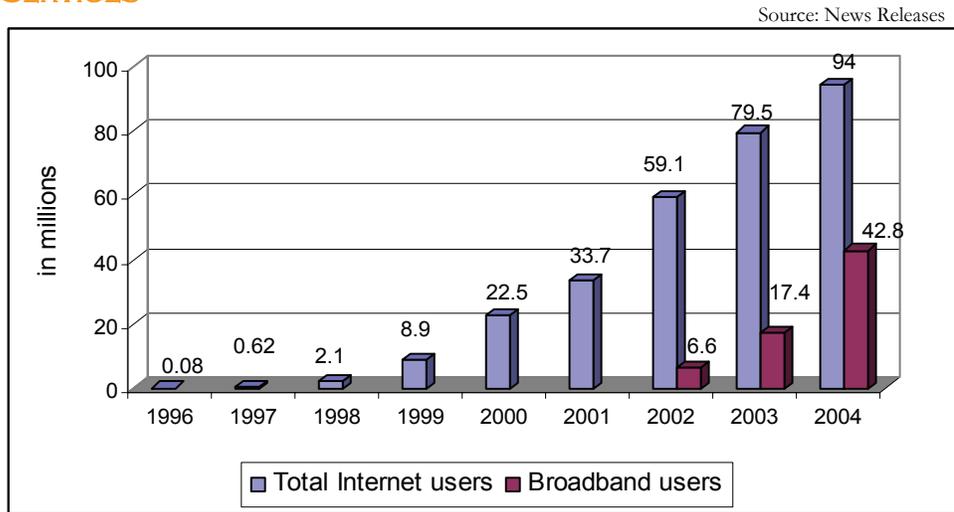
With 334 million mobile phone users and a penetration rate of 25.7%, the mobile market is far from saturation levels.

The only cause for concern is declining ARPU (Average Revenue per User).

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INTERNET SERVICES

China has experienced explosive internet growth, at a CAGR of 43% from 2000 to 2004, with internet users reaching 94 million at the end of 2004. In 2005, the subscribers have been growing at the rate of 1 million per month.

THREE TO FIVE YEAR OUTLOOK

We believe that significant revenue growth opportunities exist in the Chinese telecom market for the next three to five years.

Both fixed line as well as mobile subscribers should experience double digit growth for next couple of years.

After the fixed line and mobile subscribers growth matures, value added services would become a major growth driver, as VAS is still in the nascent stage and significant opportunities exist for tapping this area of growth.

Government projections expect Chinese internet users to reach 200 million at the end of 2007. This suggests tremendous growth opportunity for broadband services.

CN is well positioned to take advantage of industry potential. We believe in the near future that broadband and PHS subscriber growth will be the growth drivers. In the long term, Value added services should show healthy growth.



CHINA NETCOM GROUP CORPORATION (HONG KONG) LTD

CN

China@riedelresearch.com

Rating:	Price as of 12/10/05	Price Target:	52-week range:	Dividend:	Yield:
BUY	\$30.50	\$40.75	\$23.10-\$36.00	0.00	0.0%

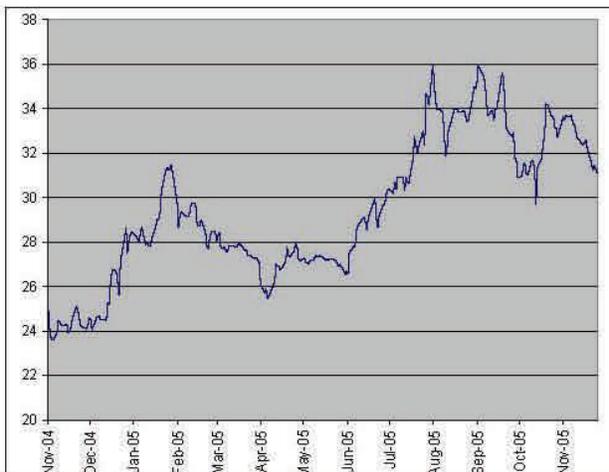
COMPANY DESCRIPTION

Incorporated in 2002, to break China Telecom Group's monopoly, China Netcom (CN) is a fixed line operator. It operates mainly in the northern part of China with a small presence in southern area.

CN offers fixed line telephony services, broadband and other internet related services, business and data communication services and international telecommunication services.

CN was listed on Hong Kong stock exchange and NYSE in November 2004. Despite a over 25% price appreciation since listing, we believe CN still has value proposition coming from a healthy revenue growth based on broadband wave in China and increasing bottom lines on account of financial discipline.

At a target price of \$40.75, we advise a BUY on CN stock.



SALES AND EARNINGS (in millions, except per-share data)

KEY RATIOS (%)

FY ends:	Sales	EBITDA	Net		EPS	CF/S	Div.	EBITDA	Tax	Net		ROE
			Income	Shares (mil.)						Margin	Rate	
12/06E	8,723	4,666	1,518	283.0	5.36	3.88	1.61	53.5%	27.6%	17.4%	17.5%	
12/05E	8,249	4,424	1,434	283.0	5.07	3.80	1.52	53.6%	25.8%	17.4%	18.8%	
12/04A	7,844	4,131	1,117	281.5	3.97	2.42	0.00	52.7%	26.6%	14.2%	16.8%	
12/03A	7,237	3,824	(1,342)	275.0	(4.88)	(1.40)	0.00	52.8%	38.0%	-18.5%	-25.6%	
12/02A	6,578	3,652	788	275.0	2.86	(0.83)	0.00	55.5%	25.3%	12.0%	10.5%	

Average Growth Rates:

05-06E	6%	5%	6%
02-04A	10%	7%	21%

QUARTERLY EPS

FY Ends:	1H	2H	Total
12/05E	2.72	2.35	5.07
12/04A	2.09	1.88	3.97
12/03A	1.88	(6.76)	(4.88)

BALANCE SHEET SUMMARY (as of 12/31/04)

Current assets	2,530	Current Liabilities	8,736
Fixed assets	15,172	Long-term debt	2,641
Other assets	2,254	Other liabilities	1,914
		Networth	6,665
Total assets	19,956	Total liabilities & equity	19,956
		L-T Debt/Capital	13.2%

VALUATION

P/E 12/06E	5.7x	Price/BV	1.3x
P/E 12/05E	6.0x	TEV/EBITDA 12/05E	3.3
Rel P/E 12/02E	N/A	Beta	1.8
Price/revs 12/05E	0.0x	Price/CFLO 12/05E	8.03

SHARE DATA

Market cap (mil.)	11,840	Convertible shares (mil)	0
Primary shares (mil.)	281.5	Institutional ownership	1.5%
Float (mil.)	N/A	Insider ownership	N/A
Avg. daily volume (00)	32.0	% of Index	N/A

RATING CHANGES

From	To	Date	Price
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PUBLICATIONS

Title	Date/No.
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Source: Riedel Research Group



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Market Pick—China Netcom Group

China Netcom (CN) turned around in FY04 driven by strong broadband and PHS growth on one hand and financial discipline, leading to improvement in margins and strong cash flows. Despite more than 25% stock appreciation from listing time, we believe CN still has a good potential. We are forecasting revenue growth at a CAGR of 7% for next two years, mainly driven by broadband and VAS growth, and earnings growth at 13%, driven by cost controls and financial discipline. CN's strategic alliance with PCCW and its recent acquisition of additional operations from its state owned parent represent further growth opportunities. Currently trading at \$30, we believe China Netcom shares are worth over \$40 and recommend buying the shares.

RECENT NEWS AND RESULTS

China Netcom recently announced the acquisition of telecom businesses in the Inner Mongolia Autonomous Region and the Heilongjiang, Jilin, and Shanxi provinces. This will increase the company's customer base by nearly 50%. Its total revenue increased 4%, despite a decline in revenue from long-distance and local phone services. Its broadband subscriber base grew 85% YOY in 1H05, with related revenue growth of 54%. Both its operating profit margin and net profit margin improved, in comparison with 1H04 and 2H04. Recently, CNC China entered into a cooperation agreement with the company to provide telecom products and services for the 2008 Beijing Olympic Games.

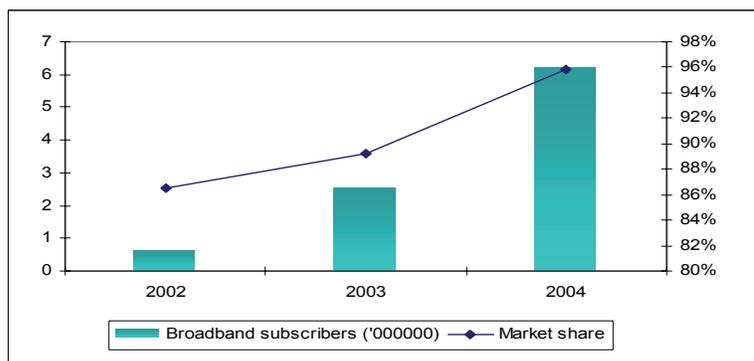


FUTURE GROWTH DRIVERS

Broadband business

We believe broadband will be the key growth driver for China Netcom. With 96% market share in the northern region, CN is already in formidable position in this segment.

CN's broadband subscribers increased from 2,535,200 to 6,218,000 – a spectacular 145.3% increase from FY03 to FY04. The need for high speed data transmission from business users, the popularity of online gaming and a meager 3% penetration of broadband among the Chinese population means tremendous growth potential for broadband services. With the increase in broadband penetration, we project broadband revenues will grow at a CAGR of 34% for next two years and constitute 13% of CN's total revenues versus 8% in FY04.



Source: Company Reports

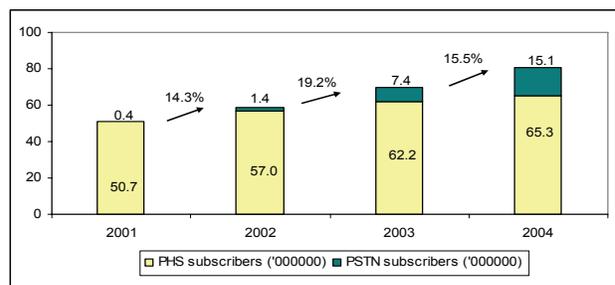
Fixed line services

CN's fixed line subscribers grew 15.5%, reaching 80.4 million in 2004. The major growth driver in this segment was Personal Handyphone System (PHS) - a localized mobile phone system. PHS subscribers for CN more than doubled to reach 15 million. The development of PHS services has mitigated the effect of mobile substitution.

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PHS, with more than 65 million customers currently, has become mainstream telecommunication service in China. The introduction of 3G is not expected to have much impact on growth of PHS segment as 3G targets the higher income segment as against the lower income segment targeted by PHS. Although the growth of PHS subscribers has slightly slowed down in last few months, CN management expect a positive growth rate for these services at least till 2008.



SOURCE: COMPANY REPORTS

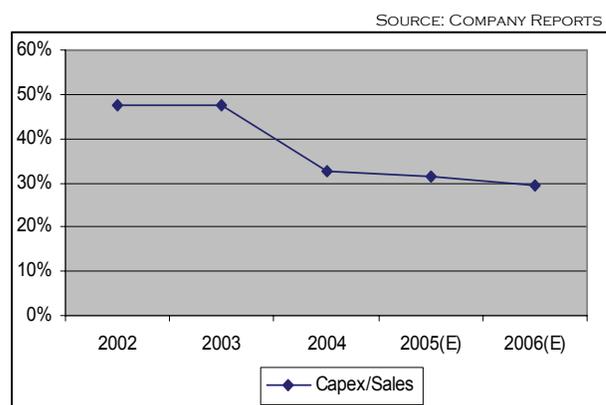
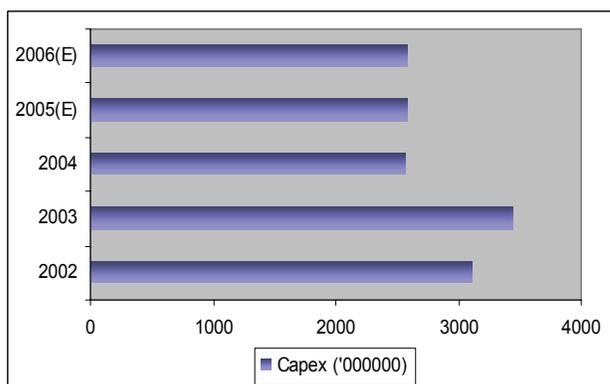
VALUE ADDED SERVICES (VAS) – A GROWING STAR

CN offers a wide range of value added services like caller identification, PHS short messaging, voice mail, teleconferencing, videoconferencing etc. The penetration of caller identification services was 58.2%, up 8.6% YOY. PHS short messaging services grew rapidly to 1,271 million in 2004, noting an increase of 1503%. CN launched personalized ring service in the northern region at the end of the season and acquired 0.34 million customers in a short span of time. Going ahead, we believe VAS will experience a healthy growth and will be one of the growth drivers in near future.

INTERNATIONAL TELECOMMUNICATION SERVICES

CN is a leading provider international telecom services in APAC with relationship with 147 international carriers (90 large and 57 small or medium operators) It acquired Asia Global Crossing in late 2002, a company that had network connecting 200 cities in 16 countries. This division now operates a regional fiber-optic submarine cable system owned by the parent China Netcom Group, which connects Japan, South Korea, Taiwan, Hong Kong, Singapore and the Philippines, the west coast of the US, Australia, New Zealand, India, Malaysia, Thailand, Indonesia and Europe. This huge network has an aggregate capacity of 15.8Gbps over 27 international submarine cables, four international terrestrial cables and other leased international circuits that connect to major cities around the world. Management expects this division to become profitable in 2006.

REDUCING CAPEX



SOURCE: COMPANY REPORTS

In addition to strong growth in broadband, VAS and PHS; CN has also strengthened its internal controls for capital expenditure by implementing stringent controls. Capex for FY04 was down 25% YOY as a result of focus on improving utilization rate of its existing network equipment, the capex policy and appropriate utilization of credit provided by suppliers. As per company guidance the capex will remain almost constant for next couple

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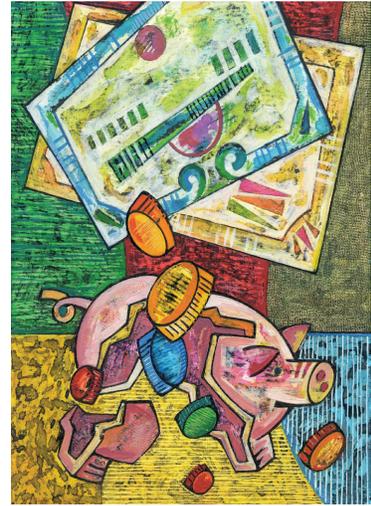
of years. The capex to sales ratio came down from 48% in FY03 to 33% in FY04. As per our estimates this ratio will further come down to 31% in FY05 and 29% in FY06, thus showing increasing financial discipline on part of CN. capex is reduced, correspondingly CN's free cash flow increased which was used to repay some part of debt, thus making a healthier balance sheet.

RISKS TO VALUATION

The major risk to CN is 3G execution. Assuming CN gets a 3G license, it will find execution difficult at least in the earlier stage. At approximately half the scale of China Telecom, and considering that it caters to the less affluent northern areas of China, huge capex required for 3G might create a dent in CN's bottom line. However, it will give CN a mobile license, which it does not have at present. This in turn will enable CN to offer a bundled fixed line package with wireless services, which should protect margins from eroding.

VALUATION

China Netcom's recent expansion will enable the company to further increase geographical coverage, and achieve higher economy of scale. Although the company's broadband subscriber grew 85% YOY in 1H05 with related revenue grew 54%, and both operating profit margin and net profit margin improved compared in 1H04 and 2H04, we are concerned about the decrease in broadband per subscriber revenue. However, the fact that it will be the exclusive fixed-line telecommunication service partner for the Olympics through its parent company will help it build up its brand name outside China. Our target price for China Netcom is \$40.75 per share. At the current price of \$30 per share (a P/E of just 6x) we believe the shares are considerably undervalued.



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1 RULE OF INVESTING: CONSIDER THE STRENGTH OF THE BALANCE SHEET

Investors tend to spend too much time focused on the Income Statement when considering whether or not to invest in a company. They ignore the Balance Sheet which can be a very important indicator of the health of the company being considered. Think of it from your own perspective. Is it more important to look at your monthly paycheck and expenses or your full financial situation when considering your financial condition? I would argue that looking at the size of your mortgage obligation, credit card debt, savings balance and other investments is an important part of the picture of where you stand financially.

This applies to companies as well. How much debt do they have? Is there a risk of them not being able to pay their debt? How much cash (savings) do they have? China Netcom's solid financial position reinforced by strong trends in earnings makes it an attractive investment.



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MARKET COMMENTARY

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Shares of China's online gaming companies, Shanda, The9, and Netease.com were down in November after releasing disappointing results amidst increased competition.

Tom Online's shares were up in November after the company reported record revenue and profits. Next month's issue will be looking at this attractive wireless value-added service provider more in detail in addition to explaining how this industry works.

We continue to recommend investing in Hong Kong and China's companies on the basis of strong investment themes such as increased trade and infrastructure, the 2008 Beijing Olympics, reasonable valuations, and strong balance sheets. It is important to note that China views the 2008 Olympics as being its biggest coming-out party to the world. In advance of this, China is spending enormous amounts of capital on infrastructure such as broadband or 3G wireless and airline transportation, to name a few.

Last month, we recommended the purchase of Ninetowns Digital World Trade, which is a play on China's growing trade (NINE shares are up 10% since we released our report). This month, we focus on China Netcom, a broadband wireless player.

China Netcom (CN), is a \$9.6B telephone and broadband leader with strong cash flows and solid profit margins. CN is relatively small, in terms of China market share. However, recent acquisitions have expanded their customer base by 50%, and expected future acquisitions should expand their customer base by another 50%. We estimate their earnings to increase 13% over the next two years. We think the stock is inexpensive at a P/E of 6.6x our projected 2005's estimated earnings per share (EPS) and 6.2x our projected '06 EPS. Our target price for China Netcom is \$40.75 per share, which is 26% higher than current trading levels.



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