

Tech and Telecom: Huawei Focus

AUGUST 20, 2019

Huawei, the Chinese telecom equipment and smartphone manufacturer, has been in the headlines for some time. From charges of illegal business activities to claims that the company poses a national security risk to the US given its ability to use its technology for spying, the company finds itself at the center of three key issues facing China and the US: the competition to establish 5G, the US-China trade war, and national security.

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In 2018, the US announced that it would impose a supply ban from US companies on Huawei equipment. By May 2019, the US Department of Commerce (DOC) announced an additional step by placing Huawei on a restricted "Entity List" by the Bureau of Industry and Security (BIS). The Entity List requires that US companies acquire a US government license to sell equipment and software to Huawei unless the Commerce Department finds such selling does not create a national security risk. On August 19, the DOC extended the deadline for an additional 90 days to allow Huawei to buy products from American suppliers. This is a continuation of the DOC's May decision to ease restrictions on Huawei by granting temporary licenses to allow certain US supplier to continue to do business with the company, as long as it did not pose a national security risk. However, the easing does not remove Huawei from the Entity List but does make it easier for companies to retain a temporary license to sell to the company. The discussions remain fluid with no full deal between the two parties.

Who is Huawei?

Huawei Investment & Holding Co., Ltd. is a private company founded in 1987. It currently has 188,000 employees and is

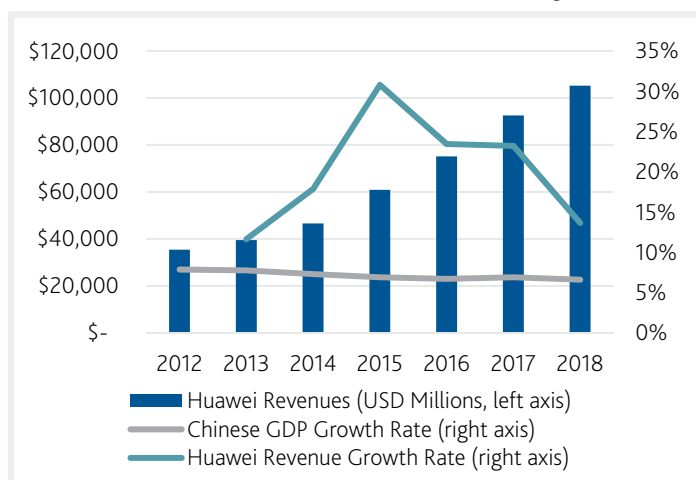
100% employee-owned through the Huawei Holding Trade Union. It operates in three segments: Carrier Business, Enterprise Business, and the Consumer Business. Over half of its revenues comes from China. It is the largest technology company in China representing 0.8% of Chinese GDP.

Although it is privately held, Huawei has over \$10bln in public debt¹. Most of its debt is issued through two wholly owned subsidiaries: Proven Glory Capital Limited and Proven Honour Capital Limited which are fully guaranteed by the company. There are no credit ratings available for these public debt issues by any of the major rating agencies.

Race to Global Dominance for 5G

Huawei's rise in the technology and telecom landscape has accelerated in recent years. While the US is the leader in the semiconductor and software space, China ranks in the top 3 (along with the US and South Korea) in terms of the number of 5G patents, smartphones, and telecom equipment. Huawei is prominent in the smartphone space, with the second highest market share (17.6%) worldwide as of 2Q19 (see table below). 5G technology is expected to support key pieces of infrastructure in the US and China. The leader for

Huawei's Growth Versus the Chinese Economy



Source: Huawei 2018 Annual Report and Macrotrends Research

Top 5 Smartphone Companies: Shipments (millions), Market Share, and Year-over-Year Growth

	2Q19		2Q18		YoY
Company	Shipments (millions)	Market Share	Shipments (millions)	Market Share	Change (%)
1. Samsung	75.5	22.7	71.5	21.0	5.5
2. Huawei	58.5	17.6	54.2	15.9	8.3
3. Apple	33.8	10.1	41.3	12.1	-18.2
4. Xiaomi	32.3	9.7	32.4	9.5	-0.2
5. OPPO	29.5	8.9	29.4	8.6	0.3
Others	103.4	31.0	112.4	32.9	-8.0
Total	333.2	100%	341.2	100%	-2.3

Source: IDC Quarterly Mobile Phone Tracker, Q2 2019, July 31, 2019
Forbes, May 2, 2019, *Huawei Has Taken Over Apple's Market Share in China; It Will Get Worse*

5G adoption will likely drive the technology for cloud computing, internet of things, and autonomous vehicles. Many global telecom operators outside of the US use internet infrastructure equipment supplied by Huawei. However, US companies do not use Huawei equipment due to national security concerns, but are using other foreign suppliers for 5G infrastructure.

Trade War and National Security

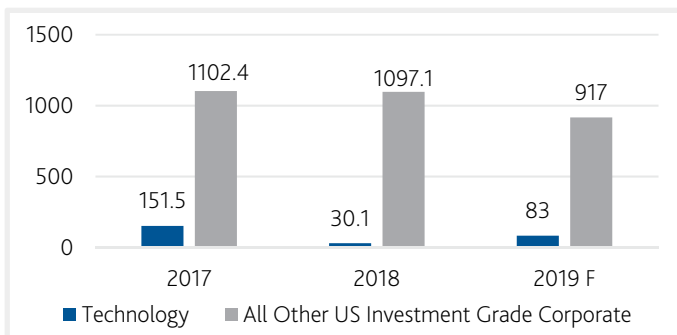
The US announced on August 1st that it would impose a 10% tariff on \$300bln of imports largely centered on consumer goods from China beginning in early September. This was pushed out to December on August 13th. This is in addition to the 25% the US already imposed on the initial \$250bln that was largely focused on industrial goods in 2018². Huawei is not only a leader of 5G in China but has also been growing internationally. According to a recent report, in 2018, Huawei internet equipment accounted for 47% of new deployments in Asia, 21% in Central and Latin America, and 18% in EMEA³. Huawei has deployed a significant amount of undersea fiber cable between continents and its network carries 95% of global internet traffic. Huawei's growth has led to US and other nations' concerns around cybersecurity, with fears mainly focused on how the Chinese government could possibly use the strength of Huawei to its advantage. However, less than 1% of US wireless customers use Huawei equipment and none of the major US internet nodes contains Huawei equipment. The US District Court for the Eastern District of New York brought fraud charges against Huawei and one of its high-ranking executives early this year⁴. The US and other countries are suspicious of Huawei and its relationship to the Chinese government. However, the company denies having any ties.

Credit Market Implications

While Huawei headlines could impact sentiment across technology and telecom names, recent rating agency comments suggest that Huawei should have a limited effect on near-term ratings. The technology and telecom sectors have been impacted by factors outside of Huawei in 2019. Calls for break-ups, regulation, and M&A have been increasing for the big tech firms. The decline in bond issuance in the technology sector, driven by access to overseas cash post tax reform, has benefitted the sector

(see chart below). Large technology companies also have amongst the strongest balance sheets. Many US semiconductor companies are key suppliers to Huawei, which is why it can have an impact on the related US credits. On the telecom side, the companies with large amounts of debt outstanding have been focused on debt reduction which should support their credit profile. 5G rollout in the US is still in its early stages, with limited revenue expectations in the near term. Huawei's impact on US investment grade telecom companies should also be minimal given less reliance on Huawei for 5G infrastructure.

Technology Issuance vs. All Other US Investment Grade Corporate Issuance (\$ USD billions)



Source: JPMorgan report on US Investment Grade Corporate issuance, July 2019

US Investment Grade Companies' Exposure to Huawei

US Companies	Rating/ Outlook	Huawei Revenue Exposure (%)	Key Customer in Latest K-10?
Qualcomm	A-/Negative	5-10	Yes
Broadcom Inc.	BBB-/Stable	4-6	No
Analog Devices	BBB/Stable	4-6	No
Marvell	BBB-/Stable	4-6	No
Maxim	BBB+/Stable	< 3	No
Intel	A+/Positive	< 3	No
Texas Instruments	A+/Stable	< 3	No

Source: S&P Global Ratings estimates, company information, June 2019

Chinese retaliation against US restriction on Huawei, including the boycott of US products, could impact US companies' sales in the region. Overall, there are ways that US companies can mitigate the Huawei impact, including: passing on price increases to customers or reducing China manufacturing exposure. Companies may also choose to absorb the associated costs and gross margin headwinds. Generally, high grade corporate credits are diversified with respect to geography and business which offsets some risk.

SOURCES

1. Huawei Company Website, *2018 Annual Report*
2. Office of the United States Trade Representative, June 2018, *Section 301 Product List Fact Sheet*
3. Barclays, June 5, 2019, *5G Leadership: Huawei in Context*
4. Department of Justice, January 28, 2019, *Chinese Telecommunications Conglomerate Huawei and Huawei CFO Wangzhou Meng Charged with Financial Fraud*

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