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# ZTE, Credit Lines, Walmart and a Long Term View for Carriers

ZTE's additional $10 billion line of credit from the Export-Import Bank of China, complementing the $15 billion line of credit it arranged earlier this year from the China Development Bank, gives it a $25 billion line of credit that strikes fear in its competitors hearts - and although it may open up financing some carriers might have a more difficult time getting elsewhere, what does it mean for the industry in the long-term?

Access to that kind of capital gives ZTE the opportunity to accelerate its international expansion efforts, engage in R&D, and significantly augment its vendor financing arrangements if it so chooses. ZTE has already been on a growth spurt, and this free flowing capital from Chinese banks at a time of a credit crunch in many other markets potentially gives ZTE the opportunity to exploit the financial crisis - and try and "buy" market share among cash constrained operators at the "price" of vendor financing.

So what's potentially wrong with that in a free market? Absolutely nothing, assuming all vendors have equal opportunity to qualify for a line of credit, on relatively equal terms based on relatively equal criteria. But how many companies that grossed $6.5 billion in top line Sales last year do you think could go to a commercial bank in a mature market and arrange a $25 billion USD line of credit right now? Or how many companies that had a net cash flow from operating activities of negative 4,486,410 thousand RMB in the quarter ended 31 March 2009 would have that kind of credit line made available to them? And how many companies that earned only 78,655 thousand RMB of net profit attributable to equity holders of the parent on 11,670,176 thousand RMB of total operating revenue in the quarter ended 31 March would get this kind of credit line - particularly when 23,060 thousand RMB of the 78,655 thousand RMB of net profit on those revenues was due to an extraordinary item (government grants accounted for in "current profit and loss")?

Any cultural differences in financial reporting aside, in our personal opinion not too many vendors would expect to gain this kind of credit line extended under similar circumstances and for similar purposes. Sure, ZTE has extremely fast top line revenue growth, but not that much profitability - and this isn't the telecom bubble anymore. Driving a lot of revenue without much profit is generally not as impressive as it once was to the financial community. And given the mixed results that vendor financing have yielded in the past, how typical is the extension of a line of credit of this size? But in our opinion we do not think it is ZTE's revenues or income statement that are driving the investment, it is the longer-term focus and strategy of ZTE, Chinese banks, and the Chinese government to fund market penetration.

The effects of globalization in a free market are a fact of life that more established vendors in mature markets are simply going to have to deal with for the foreseeable future, until wages in the emerging and more mature markets gravitate more closely toward one another. The presence of extremely cost competitive players from developing markets will make for strong downward pressure on margins and a real need for competing vendors located in more developed markets to be cost conscious in the next few years. It has already forced greater globalization of their operations, and the associated transfer of currency out of their established home markets to cover offshore operating expenses. Fair enough, that is free competition.

But if one vendor were hypothetically to have unequal access to capital, capital that could be used to offer vendor financing in a tight capital market to try and build market share, would that actually be good for carriers in the long run? Or might it potentially negatively affect their supply chain at some point, or negatively affect the future availability of products or services with differentiated value that may not be offered by the low cost supplier? And will a low cost vendor be satisfied with low margins in the long-term, particularly once their competition is reduced? And will they not have to provide a good return at some point to their investors? Or after competition has been reduced in future, might they potentially decide it is a good time to raise prices?

These are questions carriers must ask themselves, because in this economy, they need to worry about the long-term viability of their supply chain, and what impact their decisions might have on it. In the past, carriers have typically pushed to see how low they can get vendors to go on pricing, without worrying about whether their vendors are making a reasonable profit. If all business decisions were rational in the long-term, and if capital availability was relatively equally accessible to vendors of similar competitive merit and strength of business model, that would make sense.  But if for some reason this might not be the case, it might not.

Consider a parallel example with at least some similarities in another industry.  Retailer WalMart has been very successful in leveraging "cost arbitrage" - taking many goods developed and manufactured in low cost markets (like China), and selling them in more established markets with higher labor costs and higher average pricing levels. With volume purchasing, WalMart drove high sales at modest margins, building significant market share due to competitive pricing. Its growth was an impressive success story, but it has also been argued to have demonstrated just how potentially destructive "arbitrage"-driven success can be to the health of the consumers' "supply chain" of competitive retailers. For instance, in a number of smaller towns where there are relatively few retail customers to compete for, Walmart's success has squeezed out much of its competition, making consumers there sometimes finding themselves confronted with greatly reduced alternatives in their "supply chain" of retailers and products as a result.  Some other favored "suppliers" (other, established retailers) were no longer able to compete with WalMart's pricing on many of the more commoditized products they carried - and had to exit the market despite sometimes carrying a certain percentage of merchandise that was of a higher quality, or sometimes offering services of a higher quality.

When some consumers realize too late to do anything about it what they had lost in terms of supply alternatives when these competing retailers had to exit their local market, and that this was the consequence resulting from the low cost purchases they had been happily making from WalMart, it can potentially take a bit of the fun out of those deep WalMart discounts.  But because consumers have a short-term focus and typically consider the sales price without giving thought to the margin resulting for the retailer, they sometimes engaged in behavior that contributed to the loss of key suppliers.  Had they known of the consequences in advance, would they have made the same decision?

For retail and telecom alike, globalization is inevitable, and for the best in the long run.  If there are direct or indirect "arbitrage" opportunities between countries with lower cost of operations and more mature markets with higher costs in which they can sell, so be it.  That's an inevitable consequence of free trade and a situation which, though painful to some of us in mature markets, will work itself out over time.

But what if there is more than cost arbitrage going on? What if it is not just the cost differential between emerging and mature economies, but also that banking practices are not equal in both regions - resulting in greater and easier capital availability in one country? Would that potentially tilt an otherwise "level" playing field among telecom vendors and skew free trade in favor of the vendors gaining access to capital on potentially unequal terms? And if it did, what potential long-term impact might that have on the diversity and health of a carrier's supply chain and the telecom industry?

ZTE or banks in China might argue that the lack of free-flowing capital in North America and Europe was the consequence of unsound lending practices - and there is obviously some degree of merit to that argument. On the other hand, in the "post-bubble" telecom market, the kind of financing available to ZTE seems a bit out of the ordinary for this market. And competitors in Western countries like the U.S. might think that vendor financing and huge lines of credit for this purpose, R&D, and international expansion might be the modern day telecom equivalent of the hotly contested issue in the early 1980's of whether China was "dumping" candles on the U.S. market at or near cost to drive the competition out of business and raise prices later. Or they might conceivably think that receiving and reporting government grant money as part of an exceptional item that appears to directly affect P&L might have the potential effect of concealing the degree of that which might be going on.

Meanwhile, carriers are facing an ultra-competitive environment and bandwidth-hungry subscribers. So should they (or can they) even care whether all vendors do or do not have relatively equal access to lines of credit based on similar qualifying criteria and similar terms? In the long-term, yes. Those kinds of questions are particularly worth asking now, amidst these difficult financial times. In the past, many carriers have always turned a blind eye toward the financial impact of their decisions on suppliers - and concentrated on maximizing the business model and optimizing the business case for competitive equipment for the next planned network investments. Sometimes that tendency, coupled with major industry cyclical activity, killed off some secondary suppliers and startups. Acceptable casualties, from the carriers' perspective.

But now things are different. With globalization and a major downturn, there are a number of major vendors that have been considered as strategic suppliers that are not showing strong financial health. What happens if one is potentially lost? Ask a carrier with a lot of Nortel equipment in the installed base, which may be losing some sleep lately contemplating the possible scenarios right now. In today's economic environment, it is not just the start ups and Tier 3 established vendors that are potentially at risk in the next few years - there is also accelerated opportunity for some inevitable consolidation, and not just among smaller suppliers or start ups. Worse yet, in this kind of a financial crisis, there could even be short-term opportunities for consolidation above and beyond what is inevitable. And ultimately that is not good for carriers.

If a carrier does think that capital is available on relatively equal qualifications and terms, it is not something they need to consider. But if they think that the playing field of capital availability might not be level, they might want to consider the potential long-term consequences of selecting loss cost products that might derive that cost via what some countries might consider to be less than truly "free" trade.

Maintaining healthy competition in the supply chain is a good thing. A supplier that can offer low cost products and make a good profit has enviable competitive advantages in operations, however derived. But it is at least worth considering whether a low cost supplier that is not making much profit might be trying to "dump" products to "buy" market share based on price and/or vendor financing, and what the long-term ramifications of this might we.

That said, no carrier should not have to subsidize less efficient vendors if capital availability is relatively fair, and should not have to pass up on some of the legitimate cost advantages which vendors with a larger percentage of operations in lower cost markets can offer.

Any vendor with a high percentage of commodity products that can gain significant market presence based on low-margin, commoditized product sales will want to increase those margins in future if they succeed in reducing their competition. But if that vendor has access to significant capital, they may also have the ability to move up the value chain in terms of developing higher value products and services.

So good, in fact, that it might be something for which carriers might want to take some reasonable amount of responsibility - particularly as it might give them more and better options in future.