Corporate Visit

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SOCAM: Seeds of property revival

Recommendation: Not Rated | **Hong Kong Conglomerate**

Price	**HK$19.3**	**Yield (12/06A)**	3.5%
12 mth range	HK$16.2-32.6	**ROE (12/06A)**	11.7%
Market cap.	US$779.1m	**Net gearing (12/06A)**	68.1%
No. shares o/s	321.6m	**Net debt/sh. (12/06A)**	HK$13.3
Daily t/o, 3 mth	US$0.83m	**BV/sh. (12/06A)**	HK$18.2
Free float %	43.3%	**Consensus EPS**	
Major shareholder	Shui On Company– 56.7%	**- 12/07F**	na
Ticker	0983.HK/ 983 HK	**- 12/08F**	na

Key points:

- Conglomerate focused on property development and cement manufacturing in China.
- Austerity measures create brilliant expansion opportunities for CCP.
- Co-development strategy for large projects cuts SOCAM's risks.
- LSOC to benefit from the strong demand and consolidation of China's cement industry.
- Possible separate listing for LSOC.
- Dual listing planned for CCP within five years.

Company profile. Listed on the HKEX in Feb 1997, Shui On Construction and Materials (SOCAM) is a conglomerate focusing on property investment and development, and cement manufacturing in China. It operates five business divisions: distressed property assets investment, property development, cement manufacturing, venture capital and construction. SOCAM invests in distressed property assets in China via its 40.0%-owned AIM-listed China Central Properties (CCP, CCPL LN, £0.61, NR). It also owns about 12.6% in Shui On Land (272 HK, HK$7.49, NR), a property developer in China specializing in the development of large scale projects. SOCAM operates its cement manufacturing business via Lafarge Shui On Cement (LSOC), a 45:55 JV with Lafarge, a France-based world-class cement manufacturer.

Investment highlights

Unique business model. China's current economic austerity measures create brilliant expansion opportunities for CCP, SOCAM's distressed property investment arm.

Low-risk property development mode: 1) the group's exposure to risks associated with distressed property investments are limited to its interest in CCP; 2) by co-developing projects in China, SOCAM minimizes its exposure to any single project and reduces its financial burden; 3) management fee income from CCP creates another revenue source for SOCAM.

Established player. As China's seventh largest cement manufacturer, its 45.0%-owned LSOC is set to benefit from the copuntry's strong demand for cement and the sector's consolidation. LSOC plans to increase its capacity to 50.0m t.p.a. by end-2010, representing a 2-year CAGR of 46.2%.

Unlock the value. SOCAM plans to list CCP in Hong Kong or Singapore within the next five years to reflect its intrinsic value more efficiently. We believe LSOC may go public as well, which would unleash the value of SOCAM's 45.0% interests in LSOC.

Valuation. We put SOCAM's NAV at HK$21.0/share adopting a mark-to-market approach. For the cement business, we appraise the enterprise value per ton of cement production capacity (EV/ton) at HK$342.3. Our valuation is based on the average EV/ton of the following transactions:

1) in Jan 2008, TCC International (1136 HK, HK$6.09, NR) acquired CHIAH SIN Cement at about HK$2.6b. Before the acquisition, CHIAH SIN Cement had a production capacity of 4.2m tons t.p.a. and limestone reserves of 320.0m tons. The transaction in terms of EV/ton is valued at HK$615.0.

2) In 1Q 2008, Nanfang Cement, a wholly-owned subsidiary of CNBM (3323 HK, HK$19.48, NR), acquired 100.0% in Zhejiang Cement, which has a total clinker capacity of about 3.9m t.p.a.(nominal cement capacity estimated at 5.1m t.p.a.) for RMB788.4m. Zhejiang is building clinker facilities with a capacity of 5.0m t.p.a The transaction implies an EV/ton of HK$154.6, excluding the new capacity under construction.

3) In Feb 2008, Dezhou China United, a non-wholly owned subsidiary of CNBM, acquired 100.0% in Dezhou Daba, which has a total annual clinker capacity of 1.6m t.p.a. (nominal cement capacity estimated at 2.1m t.p.a.) for HK$792.0m, implying an EV/ton of HK$377.1.

4) In Jan 2008, CNBM said its subsidiary South Cement plans to acquire a nominal cement capacity of 19.5m t.p.a. for RMB4,330.0m, implying an EV/ton of HK$222.3.

Table 1: Appraised value on SOCAM

Assets	Description	Valuation	Weighting
Shui On Land	Mark-to-market: 526.3m shares @HK8.1	4,273.4	39.8%
China Central Properties	Mark-to-market: 120.6m shares @HK$8.6	1,033.1	9.6%
Cement division	EV/ton@HK$, attributable capacity of tons	4,117.9	38.4%
Construction	By estimation	635.0	5.9%
Venture Capital	By estimation	508.0	4.7%
CB of CCP	Debt component at of the end of June 07	165.0	1.5%
Estimated net debt		(3,974.0)	
NAV (HK$m)		6,758.4	
NAV/share (HK$)		21.0	

Source: SBI E2-Capital

Risk factors: 1) Low transparency of the group's cement division; 2) connected transactions within Shui On Group; 3) SOCAM's vulnerability to the interest rate cycle. At end-FY12/07F, its net gearing stood at 85.8%; 4) difficulties in transferring funds to China by Hong Kong-based SOCAM due to government controls on inflow of funds into the country; 5) intense competition in China's cement industry; 6) difficulties in obtaining financing from banks in China; 8) economic austerity measures; 9) weak sentiment in China's property sector.

Cement: market leader in southwestern China. SOCAM and Lafarge, a France-based world-class cement manufacturer, formed LSOC, a 45:50 cement manufacturing JV in China in 2005. At end-2007, LSOC owned two cement plants in Beijing, five in Chongqing, three in Guizhou, three in Sichuan and five in Yunnan, with a combined capacity of 23.4m t.p.a. The company plans to expand its capacity to 50.0m t.p.a. by 2010. Its current overall utilization rate is estimated at 76.1%. After the acquisition of Shuangma's cement plants in 2H07, LSOC has become the market leader in Sichuan province, with 44.0% of the market.

Beneficiary of industry consolidation. China's strong fixed-asset investment growth is fuelling demand for cement, with the market expanding at a CAGR of 13.0% in 2000-2006. In 2007, According to China Cement Net, LSOC was the country's seventh largest cement producer in terms of clinker output. To consolidate the country's highly fragmented cement sector, the National Development and Reform Commission (NDRC) aims to reduce the number of kilns to 3,500 by 2010 from 5,100 currently. This will create acquisition opportunities for LSOC and reduce price competition from small manufacturers.

Table 2: China's 15 largest cement producers based on clinker capacity in 2007

Rank	Company	Clinker production capacity (m t.p.a.)
1	Anhui Conch	71.4
2	China United Cement	19.9
3	Jinan Sunnsy	18.3
4	Huaxin Cement	18.2
5	Taiwan Cement	17.6
6	Tangshan Jidong	14.0
7	LSOC	13.4.
8	CNMC	12.9
9	Zhejiang Hongshi	12.1
10	China Resources Cement	11.1
11	Asia Cement	10.9
12	Zhejiang Leomax	10.4
13	Henan Tianrui Cement	9.8
14	Henan Tongli Cement	7.8
15	BBMG Group	7.0

Source: China Cement Net

Separate listing possible. SOCAM's own cement production capacity stands at 1.5m tons. Since cement manufacturing is very capital intensive and LSOC has aggressive expansion plans, we believe that LSOC may go public to raise capital. This would unleash the value of SOCAM's 45.0% interest in LSOC.

Sowing the seeds of property revival. The Chinese government's efforts to stem the formation of an asset bubble in the country's property market by restricting loans to developers with weak development capabilities, low credit ratings or high gearing ratios created many distressed assets. This allows sophisticated developers, such as SOCAM, to acquire these semi-completed projects at a relatively low cost. Risks associated with such assets, in terms of the property market's movement and economical changes, are much lower than with green field projects. Typically, it takes only 12 months to develop and sell partially-developed projects.

CPP poised to capture opportunities. SOCAM has been engaged in the distressed property development business in China since 2005. In less than 18 months, it established a number of consortia with investors such as JP Morgan, Spinnaker Group, V Ventures Group, Value Partners and Yida Group and built up a portfolio of distressed assets located in Beijing, Dalian, Qingdao and Chengdu. They include four partially-completed projects, one recently completed and upgraded property and a contract to acquire a partially-completed project in Qingdao. To expand its distressed property business, SOCAM and other cornerstone investors have formed China Central Properties (CCP), injected their distressed asset portfolios into it and listed CCP on the AIM board of the London Stock Exchange. The company plans to list in Hong Kong or Singapore within the next five years. Incorporated in the Isle of Man, SOCAM's 40.0%-owned CCP positions itself as an active distressed property project investor in China, focusing on medium to large projects in major and second-tier cities. It may also invest in green field projects that conform to its investment criteria.

Table 3: CCP's projects in hand

Project	Type	Location	Completion time	GFA (sq.m)	Est. market value at completion (RMBm)
Xiwang Building	Com and ret	Dalian	2007	89,000.0	1,160.0
Central Int'l Plaza (Blocks A&C)	Com, res and ret	Qingdao	4Q07	63,000.0	765.0
Huitong Building	Serviced apartment, hotel, com and res.	Chengdu	Phase1: 2Q08 Phase2: 3Q09	120,000.0	1,050.0
Shengyuan Centre	Com	Beijing	1Q08	42,000.0	820.0
Huapu Centre Phase I	Com and ret	Beijing	4Q07	125,000.0	2,000.0
Fengqiao Villas	villa	Beijing	2008	51,000.0	1,300.0
Ruiqi Building	Ret, com, res	Chongqing	2009	86,000.0	975.0
Central Plaza	Ret, com, res, serviced apat.	Shenyang	2011	296,000.0	1,779.0

Source: China Central Property

Other income sources. CCP's investment portfolio is managed by SOCAM Asset Management, SOCAM's wholly-owned subsidiary. The company identifies investment opportunities and provides preliminary recommendations to CPP. Its services include due diligence, development plan review, budgeting, negotiations, transaction structure design and financial evaluation, while SOCAM is in charge of securing bank loans for the projects. SOCAM Investment Management also provides project teams to oversee acquired developments, identifies divestment opportunities for CCP and assists CCP during project disposals. Its annual fees are calculated at 2.0% of CCP's total invested equity capital. If the internal rate of return (IRR) of CCP's project exceeds 10.0%, SOCAM Investment Management is entitled to a performance bonus of 20.0% of the cash flow generated by the project. This recurrent management fee and performance-linked incentives create extra sources of income for SOCAM, in addition to dividend income and booked gains resulting from the appreciation of CPP's share price.

Lowering risks. After CCP's listing, SOCAM treated its stake in CCP as interests in jointly-controlled entities and avoided consolidating CCP's debt into its own balance sheet. The group's exposure to risks associated with distressed property investments is limited to its interest in CCP. It does not consolidate the numbers of CCP's distressed asset portfolio into its own accounts.

Leveraging on Shui On's China expertise. Shui On Group, SOCAM's parent, has been active in China's property market since the 1980s. SOCAM has been engaged in the building and construction, contracting, interior fitting out and building renovation works, property development in Hong Kong and China since its listing in 1997. CPP can leverage on SOCAM's strong capabilities in integrating its construction, property and financial structuring expertise and Shui On Group's broad network in China. SOCAM's key executives have been transferred to SOCAM Investment Management.

High returns. The company's eight projects in Beijing, Qingdao, Chengdu, Chongqing and Shenyang have an estimated aggregate GFA of 872,000.0m^2 and market value of RMB9.8b (estimated in 1H07 by DTZ and Savills). The group plans to acquire a property project in Chongqing and Guangzhou with an aggregate GFA of 178,000.0m^2 this year. CCP and SOCAM Investment Management select projects strategically located in targeted cities, offered at a discount to their market value and with IRRs exceeding 25.0%. CCP bought Xiwang Building (GFA of 89,000.0m^2) in Dalian for US$46.0m, compared with its market value of US$62.5m. Most of the company's distressed properties have already undergone the relocation of former occupiers and other land preparation work, eliminating many cost and time uncertainties. As such, risks associated with distressed property assets are lower than those related to conventional projects developed from scratch.

Structure of CCP. Immediately after its listing, CCP acquired from SOCAM and co-investors five distressed property projects in China with a total GFA of about 424,270.0m^2 for £119.0m, satisfied by the issuance and allotment of 119.0m shares at £1.0 each. It also raised US$535.0m by floating 179.6m new shares on the AIM market at £1.0 each and issued a five-year term convertible bond (CB) with a face value of US$200.0m and annualized coupon rate of 2.0% in Jun 2007. At end-Jun 2007, CCP had 298.6m shares outstanding. Its major shareholders include SOCAM (40.0%), Spinnaker (15.0%), Penta (9.0%), Och-Ziff (6.0%), Yida (6.0%), UBS (3.0%) and Goldman Sachs (2.0%). SOCAM, CQS Convertible and Quantitative Strategies Master Fund, Deutsche Bank, Highbridge, Och-Ziff and Stark Investments subscribed to US$25.0m, US$25.0m, US$67.5m, US$25.0m, US$37.5m and US$20.0m worth of CB, respectively, which allowed them to convert it into shares at £1.34 each. At end-Jun 2007, CCP was in a net cash position of US$207.3m.

SOL: conventional developer in China. Listed in Oct 2006, Shui On Land (SOL) is a flagship property developer of SOCAM's parent, Shui On Group. SOL has been engaged in property development and investment in China since 1985, specializing in large scale multi-phase integrated property projects based on master plans in conjunction with local governments. SOL focuses on city-core and integrated residential projects. Its city-core projects are strategically located, large scale and multi-phase, and typically consist of residential, office, retail, entertainment and cultural properties, with a blend of historical restoration and modern architecture. Its integrated residential projects are large scale and multi-phase, and include residential accommodation, schooling facilities, commercial and retail premises, as well as recreational areas.

SOL's land bank. At end-Jun 2006, SOL's attributable land bank totaled 8.7m m^2 and completed GFA held for sale 76,000.0m^2. The group's gross saleable GFA was estimated at 89,000.0m^2 at end-2007. The company will add 242,000.0m^2 of saleable GFA by end-2008 and 413,000.0m^2 by end-2009. Its leasable GFA was estimated at 253,000.0m^2 at end-2007 and 108,000.0m^2 will be added in 2008 and 206,000.0m^2 in 2009.

Divestment. At end-Jun 2007, SOL had 4,185.1m shares outstanding and SOCAM had 17.8% in SOL. In Aug 2007, the group disposed of 220.4m SOL shares at about HK$8.20 each, reducing its stake to 12.6%, or 526.3m shares. SOCAM recognized a net disposal gain of HK$930.0m, including about HK$824.0m previously included in the reserves. On 4 March, SOCAM announced that it would dispose of more SOL shares. Based on the minimum offer price of HK$7.68 each, SOCAM can sell up to 130.2m SOL shares, reducing its stake to about 9.5%, or 396.1m shares. Based on the investment cost of HK$3.86 per share and the minimum offer price of HK$7.68, the group should book a disposal gain of HK$497.0m. Market estimates put SOL's NAV per share at HK$9.4 in FY12/07F and HK$13.1 in FY12/08F.

Co-development. SOCAM also participates in property development in China by teaming up with other parties, including affiliates such as CCP and SOL. In 2007, it formed a JV with SOL and Yida Group, a developer in northern China, to develop Dalian Software Park Phase II. The whole 3.6m m^2, US$2.0b project will be developed in six phases over eight to ten years. This February, SOCAM formed a 50:50 JV with CCP to acquire and develop a 57,400.0m^2 site in Chengdu. This March, it formed a 40:40:20 JV with CCP and Spinnaker Capital Group to acquire and develop a 79,704.0m^2 site in Shenyang with a GFA of 660,000.0m^2.

Risk cutting strategy. By co-developing projects in China, SOCAM minimizes its exposure to any single project and reduces its financial burden. Its effective stakes in projects developed with CCP and SOL are higher than its headline interests.

Other businesses. SOCAM has 65.5% in Yangtze Ventures and 75.4% in Yangtze Ventures II. It also owns 66.8% in On Capital China Fund, formerly known as On Capital China Tech Fund. Together, the three finds invested in 15 direct investment projects. SOCAM's venture capital business has a sound track record. For example, its investment in Solomon Systech rose c 870.0% from its cost. SOCAM is still engaged in construction, though it is no longer its core business. SOCAM's construction division now focuses on government and institutional facilities, as well as fitting-out work in Macau's hospitality sector. In FY12/07F, the division completed contracts with a gross value of about HK$2.4b. At end-FY12/07F, its contracts outstanding value stood at HK$3.2b.

Macro backdrop. China's population of about 1.32b at end-2007 is expected to reach 1.36b by end-2010 and 1.45b by end-2020. The country's urbanization rate increased to 44.9% in 2007 from 43.0% in 2005 and is expected to top 50.0% in 2020 and 70.0% by 2050. This will boost demand for urban housing. The country's GDP grew at a CAGR of 13.9% in 2000-2007, from RMB9,921.0b to about RMB24,661.9b. Between 2003 and 2007, the average disposable income in urban areas increased at a CAGR of 12.9% from RMB8,472.0 to RMB13,786.0. Savings of urban residents, measured as RMB deposits, increased at a CAGR of 13.6% in 2003-2007, from RMB10,361.7b to RMB17,253.4b. Net savings accounted for about 50.0% of the GDP in 2007. The high savings rate implies high housing affordability and rapid demand growth. China's real estate investment increased at a CAGR of 25.6% in 2003-2007, from RMB1,015.4b to RMB2,528.0b. In 2007, investment in residential commodity properties increased 32.1% YoY to RMB1,801.0b. The GFA of new completions in 2007 increased 4.3% YoY to 58,236.0m^2 and total GFA sold and total residential commodity GFA sold increased 23.2% YoY and 24.7% YoY to 76,193.0m^2 and 69,104.0m^2, respectively. Between 2000 and 2005, the average price/m^2 of residential properties increased at a CAGR of 8.6% and commercial properties 9.0%.

Sound long-term outlook. China's GDP grew 11.4% YoY in 2007, according to estimates. The cold spell in 1Q2008 and weak external environment should slow the growth down to 8.0-9.0% this year. The government will continue tightening credit and more interest rate hikes are expected in 2008 in a bid to contain inflation. This will weaken sentiment in China's property market in the short term but we believe its long-term prospects remain bright. The negative interest rate environment and strong RMB will further fuel demand for real estate.

Austerity measures. The Chinese government has introduced a series of polices since early 2003 to control the country's property market and prevent the formation of an asset bubble:

loan restrictions - banks forbidden to extend substantial loans to developers with weaker development capabilities, low credit ratings or high gearing ratios.

mortgage rates - banks to quote higher mortgage rates for high-end residential properties

transparent land transfers - land for commercial or residential use to be transferred through public auctions, public listings or tender only.

local governments made responsible for stabilizing their own housing prices, low to medium quality housing to account for the majority of units on offer.

suspension of villa developments.

increased supply of mid-tier housing for the mass market - 90.0m^2 designated as a benchmark separating high-end housing. A 70/90 rule introduced in 2006 - requires each municipality in China to ensure that units of 90.0m^2 represent 70.0% of all residential units provided.

rationalizing the scale and pace of housing demolition.

eradication of unlawful practices in property development and sales transactions.

promoting the efficiency and transparency of the property market.

tightening restrictions on foreign investment - foreign investors required to set up foreign investment companies to own their property investment in China.

restrictions on property investment by branches or representative offices of foreign enterprises and foreign individuals.

concessions for residents of Hong Kong, Macau and Taiwan or overseas Chinese.

compliance review and tax clearance procedures required before remitting any property sales proceeds out of China.

land appreciation tax (LAT) - payable on gains realized on the transfer of land, buildings and associated structures and on taxable gains derived from companies and individuals from the transfer of ownership of real estate. Effective from Feb 2007, 30-60% LAT is payable when a property is completed and units are all sold out, or the ownership is transferred entirely. LAT is not applicable to units smaller than $140.0m^2$.

China's cement industry. Since the 1980s, China has been the world's largest cement producer and consumer, according to the China Cement Association. In 2006, it produced 1,240.0m tons of cement, about 48% of the world's total. The country's domestic cement production increased at a five-year CAGR of 13.0% in 2000-2006, bolstered by its robust fixed asset investment. China's cement production increased 16.0% YoY to 620.0m tons in 1H07.Traditional vertical kilns and other old processes have been replaced with new dry process technologies, offering higher energy efficiency and end-product quality.

Government goals. During the 11th-Five Year Plan, China aims to:

produce 1.25b t.p.a. of cement by 2010 using new dry process technologies;

produce 70.0% of its total cement output by the new dry process.

boost the capacity of its top ten producers to at least 30.0m t.p.a.

cut the sector's energy consumption by 25.0%.

Consolidation. Cement is a bulk commodity and transportation of its raw materials and finished products represents a large chunk of its total production cost. As a result, cement production and market competition are highly localized. According to the China Building Material Industry Association, cement plants are generally located close to limestone deposits and cement products are generally sold within a 300 kilometer radius. Given these constraints, demand for cement is largely affected by local GDP growth and local fixed assets investment. To consolidate the highly fragmented sector, NDRC plans to reduce the number of kilns from 5,100 now to 3,500 by 2010.

Table 4: P&L

(HK$m)	FY05A	FY06A	1H FY06A	1H FY07F
Turnover (Group's)	1,882.9	1,680.4	843.0	1,413.0
Other income	22.5	70.7	37.0	42.0
Change in inventories	(125.7)	25.2	28.0	55.0
Raw materials and consumables used	(260.4)	(244.8)	(127.0)	(219.0)
Staff costs	(244.7)	(215.4)	(142.0)	(164.0)
DD&A	(13.0)	(5.6)	(4.0)	(4.0)
Subcontracting, external labour costs and other expenses	(1,275.3)	(1,308.6)	(625.0)	(1,127.0)
Dividend income from available-for-sale investments	-	-	-	45.0
Increase (decrease) in fair value of investment properties	-	1.4	-	17.0
Loss on disposal of investment property	(6.5)	0.0	-	-
Net increase in fair value of financial assets at fair value through P&L	(0.8)	48.1	(16.0)	-
Net increase in fair value of financial instruments		593.3	534.0	2.0
CB:Fair value changes on embedded derivatives	-	-	(21.0)	(182.0)
CB: Imputed interest expense	-	-	(16.0)	(48.0)
Finance costs	(15.2)	(165.9)	(88.0)	(93.0)
Impairment loss recognised in respect of goodwill arising on acquisition of subsidiaries	-	-		-
Impairment loss recognised in respect of interests in JCE	-	-	(1.0)	-
Gain on disposal of interests in JCEs			0.0	110.0
Change in fair value of net assets contributed to JCE	-	-		-
Gain/(Loss) on partial disposal of interest in a subsidiary	345.7	(9.7)	(10.0)	-
Gain (loss) on deemed disposal of an associate	-	119.1	79.0	(21.0)
Loss on deemed disposal of interest in an associate	-	0.0	-	-
Share of impairment loss of JCEs	-	(84.3)	-	-
Share of results of JCEs	170.8	83.5	40.0	252.0
Share of results of associate	65.1	48.8	(8.0)	(9.0)
Pre-tax profit	**545.4**	**636.2**	**503.0**	**69.0**
Taxation	(1.2)	(7.7)	(6.0)	(6.0)
Profit for the year-continuing operations	544.2	628.5	497.0	63.0
Loss for the year-discontinued operations	(59.6)	(6.1)	(5.0)	-
Minority interests	(2.7)	(20.3)	(1.0)	(3.0)
Net profit	**481.9**	**602.1**	**491.0**	**60.0**
Dividend	235.3	267.9	119.0	198.0
Basic EPS (HK$)	1.79	2.17	1.78	0.21
F.D.EPS (HKS)	1.62	0.06	1.51	0.21

Source: Company Note: 1) FY05A ended March 2005. 2) Nine months of FY06A ended December 2006. 3) 1H FY06A ended September 2006. 4) 1H FY07F ended June 2007.