SBI China Capital

Equity Research Report
22 May 2014

Company Flash

Tianjin Capital Environmental Protection Group 1065 HK

Adopting a conservative expansion plan

- *We met with TJCEP to obtain more updated information of the company and the wastewater industry.*
- *BEWG outshines TJCEP given its high profitability, low financing cost, and fast expansion plan.*
- *Its H-shares are trading at a 55.6% discount to its A-shares. We believe the gap will narrow once Chinese investors are allowed to invest in the HK market later this year.*

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Stock Data (1065 HK)

Rating	Not Rated
Price (HK$)	4.21
Target Price (HK$)	n.a.
12m Price Range (HK$)	2.39-5.2
Market cap. (HK$m)	11,732.4
Daily t/o (HK$m)	25.1
Free float (%)	89.3

Source: Bloomberg

What's new. Last week, we met with the management of Tianjin Capital Environment Protection Group ("TJCEP"), one of the leading water treatment companies based in Tianjin, in order to obtain more updated information regarding its recent business operations, future plans, and prospects of the water treatment industry in China.

Our view. TJCEP underperforms BEWG (0371 HK, HKD4.98) in terms of the profitability of its wastewater treatment (WWT) projects. Over the past 5 years, TJCEP's WWT business commanded gross profit margin of ~40.0%, while that of BEWG was ~60.0%.

Also, BEWG has much lower borrowing costs relative to its peers (4.9% vs. 6.4% and 8.7% of TJCEP and Sound Global (0967 HK, HKD 6.93) in FY12/13, respectively), this is mainly achieved by its strong relationship with the Beijing Government. As WWT companies normally need to finance a large part of their projects by debt, higher financing costs would also mean lower IRR for the projects.

Furthermore, TJCEP has deployed a conservative expansion strategy over the past few years, indicated by slow inorganic growth from new project acquisitions. From FY12/10 to FY12/13, the company obtained only 2 new WWT projects, while BEWG and CEI secured 134 and 5 new WWT projects, respectively, during the same period.

Valuation-wise, the company is currently trading at a 17.1x trailing P/E for 2013 and a 16.3x P/E for 2014E, both of which are at a discount to its peers, due to lower profitability and slower inorganic growth. That said, the company is trading at a 55.6% discount compared to its A-shares in China. The valuation gap between the dual-listed stocks may become narrower after China investors are allowed to invest in HK market later this year.

Figure 1: Financials and valuation

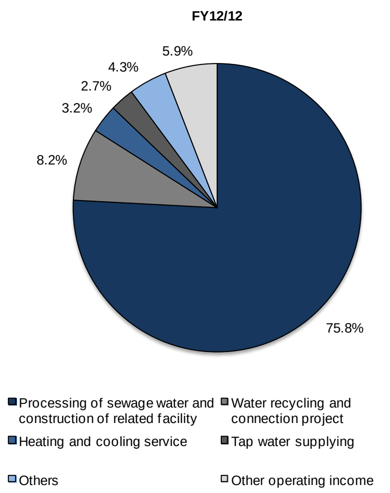
	FY12/11	FY12/12	FY12/13
Total revenue (RMB m)	**1,562.5**	**1,637.3**	**1,749.9**
Revenue growth (YoY)	*6.5%*	*4.8%*	*6.9%*
EBIT (RMB m)	**379.3**	**351.7**	**368.7**
EBIT growth (YoY)	*3.4%*	*-7.3%*	*4.8%*
Net profit (RMB m)	**279.9**	**274.6**	**288.4**
Net profit growth (YoY)	*1.7%*	*-1.9%*	*5.0%*
EPS (RMB cents)	**19.3**	**18.8**	**19.8**
DPS (RMB cents)	4.0	6.0	8.0
P/E (x)	17.5	17.9	17.1
Dividend yield	1.2%	1.8%	2.4%

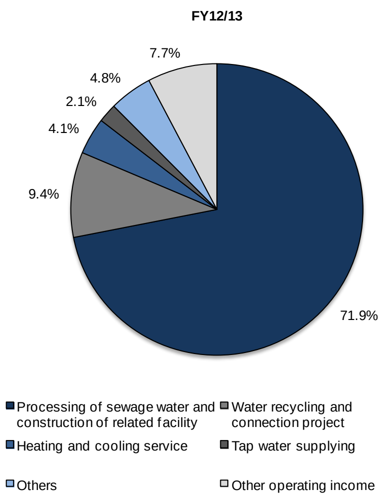
Source: The company

Company Background

TJCEP was established in 1993 in Tianjin. The company is mainly engaged in wastewater treatment, water recycling, and a water supply business. Sewage water treatment is the main revenue contributor, making up 75.7% of its revenue in FY12/13. On the other hand, revenue from water recycling and its water supply business accounted for 9.9% and 2.2% of its total revenue in the same year, respectively. The company is also engaged in heating and cooling services and a toll collection business; however, these are only auxiliary businesses and accounted for a very small proportion of its total revenue (See Figure 2).

Figure 2. Revenue breakdown by segment in FY12/12 & FY12/13

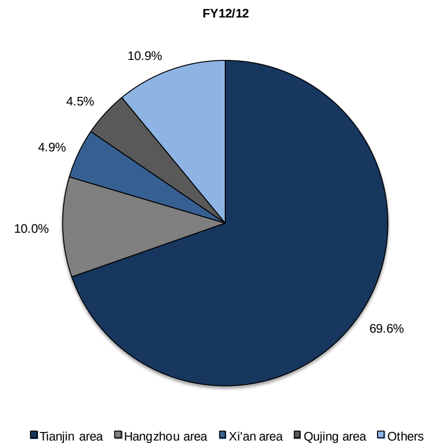


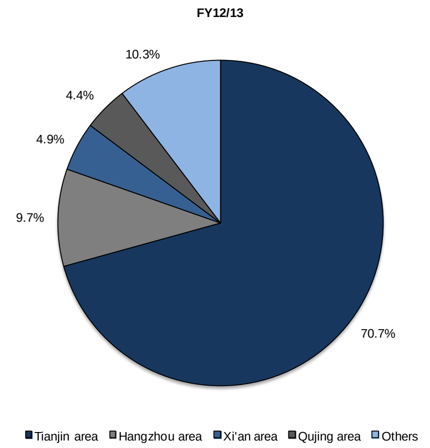


Source: The company

In terms of geographic location, Tianjin is the largest market of the company, accounting for 69.6% and 70.7% of its total revenue in FY12/12 and FY12/13, respectively. It is not surprising that its business in Tianjin made up such a significant proportion of its income, given: i) the company first developed its business in Tianjin before expanding it to other cities, and ii) the company is based in Tianjin and is held in part by the Tianjin Municipal Government. (Currently the Tianjin Municipal Investment Company Limited, which is an investment vehicle of the Tianjin Municipal Government, holds a 51.6% equity interest in the company). Therefore the company has a better chance to obtain WWT projects in Tianjin than in other cities.

Figure 3. Revenue breakdown by geographic location in FY12/12 & FY12/13





Source: The company

Currently the company conducts its WWT business under Build-Operate-Transfer (BOT) and Transfer-Owned-Transfer (TOT) models (the majority of which fall under the TOT model, as sewage treatment plants have already been built in major cities), with an average concession period of ~20 years. The company's WWT plants spread in 12 cities in China, including Tianjin, Hangzhou, Guizhou, etc. (See Figure 4). At the end of FY12/13, the company had a sewage water processing capacity of 3.71m cubic meters per day.

Figure 4. The detail of the company's WWT projects

Plant location	Agreement date	Cutomer
Dong Jiao, Tianjin	18/2/2014 (1st agreement signed in 2000)	Tianjin Sewage Company ("TSC")
Ji Zhuang Zi, Tianjin	18/2/2014 (1st agreement signed in 2000)	TSC
Xian Yang Lu, Tianjin	18/2/2014 (1st agreement signed in 2000)	TSC
Bei Cang, Tianjin	18/2/2014 (1st agreement signed in 2000)	TSC
Chao hu, Anhui	25/8/2011	Hanshan Housing and Urban Construction Bureau
Qu Jing, Yunnan	16/8/2011	QuJing Housing and Urban Construction Bureau
Ying Dong, Anhui	10/8/2009	Fuyang Yingdong Construction Bureau
Xian Ning, Hubei	16/10/2008	Xianning Construction Committee
An Guo, Hebei	14/10/2008	An Guo Municipal Government
Xi An, Shaanxi	18/3/2008	Xi'an Infrastructure Investment Group
Wen Deng, Shandong	19/12/2007	Wendeng Construction Bureau
Jing Hai, Tianjin	12/9/2007	Tianjin Tianyu Science Technology Park
Hang Zhou, Zhejiang	20/11/2006	Hangzhou Sewage Company
Hong Hu, Hubei	29/12/2005	Honghu Construction Bureau
Qu Jing, Yunnan	25/12/2005	Qujing City Water General Company
Fu Yang, Anhui	18/12/2005	Anhui Fuyang Construction Committee
Chi Bi, Hubei	15/7/2005	Chibi Construction Bureau
Bao Ying, Jiangsu	13/6/2005	Baoying Construction Bureau
Gui Yang, Guizhou	16/9/2004	Guiyang City Administration Bureau

Source: The company

Our view

BEW is more attractive with higher profitability. BEW trumps TJCEP in terms of profitability of its WWT projects. Over the past 5 years, BEW's WWT business commanded gross profit margin of ~60.0%, while that of TJCEP commanded only ~40%. We believe the outperformance by BEW is mainly attributable to its economies of scale. In fact, BEW is a much larger WWT company, with operational sewage water processing capacity of 9.5m cubic meter per day (versus 3.71m cubic meter per day of TJCEP, and 1.78m cubic meter per day of CEI), covering most cities in the eastern and southern part of China. A larger operational size allows the company to lower its cost by allocating its water facilities near its regional headquarter, as well as by sharing labor and other resources within the region.

Borrowing costs are lower than Sound Global but higher than BEI. The effective borrowing costs of TJCEP was 6.4% in FY12/13, which is lower than 8.7% of Sound Global, a private company engaged in a BOT model and Engineering, Procurement, and Construction (EPC) projects. Effective borrowing costs of BWI during the year were 4.9%, which was the lowest among the three companies. We believe the competitive borrowing rate achieved by BEW was attributable to its strong relationship with the Beijing Government, which enables it to obtain funds in the overseas market (effective interest rate of its corporate bond was ~4.0%, while that of TJCEP's corporate bond and Sound Global's senior notes were ~6.0% and ~15.0%, respectively).

Financing costs play a critical role in WWT companies' profitabilities. As the WWT business is highly capital intensive in nature (especially under the BOT and TOT models), companies normally needs to finance their capex mostly by debt. Therefore higher financing costs would also mean lower IRR for WWT projects. This also explains why TJCEP's WWT projects commands lower IRR than that of BEW (8.0% vs. 10.0%).

Slow project acquisition reflects a conservative expansion strategy. Historically TJCEP has employed a conservative growth strategy with reliance on the organic growth from its existing projects, which is driven by the increase in water tariff and urbanization. As shown in figure 4, the company obtained only 2 new WWT projects from FY12/10 to FY12/13. (We do not regard the 4 projects signed in Feb 2014 as new projects as they are merely moving from a Build-Operate-Owned (BOO) model to a BOT model). On the other hand, BEW and CEI respectively secured 134 and 5 new WWT projects during the same period. (CEI obtains less WWT projects than BEW because it mainly focuses on its waste-to-energy (WTE) business). TJCEP has a close relationship with the Tianjin Municipal Government, which should give it an advantage in securing new projects. The slow project acquisition over the past three years, in our view, reflects a certain degree of conservatism of the company's management, which is also the reason behind its slow growth among its peers (See Figure 5).

Figure 5. Revenue from WWT business

	FY12/10	FY12/11	FY12/12	FY12/13	3-Year CAGR
TJCPG (RMB '000)	1,220,294	1,270,551	1,241,607	1,258,649	1.0%
BEW (RMB '000)	591,600	994,700	1,425,000	2,140,900	53.5%
CEI (HKD '000)	856,714	804,505	1,267,442	1,283,630	14.4%

Source: The company

Valuation

The company is currently trading at a 17.1x trailing P/E for 2013 and 16.3x P/E for 2014E, while its peers on average are trading at 24.3x and 19.5x respectively. We believe the discount that the company is trading at relative to its peers is attributable to i) lower profitability as indicated by lower ROE and ROA, and ii) slower growth due to its conservative expansion plan, which led to slow inorganic growth in the past.

Figure 6. Peer comparison

Company	Ticker	Mkt Cap (HKD m)	3M avg turnover (HKD m)	2013 P/E (x)	2014E P/E (x)	P/book (x)	ROE (%)	ROA (%)	Dvd Yield (%)	Net Debt/Total Equity
Tianjin Capital Environmental Protection Group	1065 HK	11,732.7	25.1	17.1	16.3	1.7	7.3	2.6	2.4	67.7
Beijing Water Group	371 HK	43,105.0	149.1	35.6	25.9	3.2	10.0	2.9	1.0	86.6
China Everbright International	257 HK	44,030.0	169.3	30.1	24.8	3.3	12.2	6.6	0.9	8.3
Sound Global	967 HK	10,168.4	30.2	17.0	14.3	2.3	14.8	5.4	n.a.	7.1
CET Environmental Group	1363 HK	6,634.0	71.7	27.1	20.1	10.1	n.a.	n.a.	n.a.	150.3
	Average	**22,306.1**	**90.4**	**24.3**	**19.5**	**3.8**	**11.1**	**4.4**	**1.4**	**64.0**

Source: The company

That said, the company is currently listed in both China and HK, and its A-shares are trading at a high premium compared to its H-shares. While its A-shares are trading at RMB7.62 per share, its H-shares are trading at HKD4.21 per share, representing a 55.6% discount relative to its valuation in mainland China. Since China investors will be allowed to invest in HK equities later this year, the valuation gap between the dual-listed stocks may become narrower in the future.

Figure 7. Per share items

	FY12/11	FY12/12	FY12/13
EPS (RMB cents)			
- Basic & diluted	19.3	18.8	19.8
DPS (HKD cents)	4.0	6.0	8.0
BVPS (RMB cents)	324.2	164.1	199.4

Source: The company

Figure 8. Ratio analysis

	FY12/11	FY12/12	FY12/13
Growth (YoY)			
Revenue	6.5%	4.8%	6.9%
Operating profit	3.4%	-7.3%	4.8%
Net profit	1.7%	-1.9%	5.0%
Margins			
EBIT margin	24.3%	21.5%	21.1%
Net profit margin	17.9%	16.8%	16.5%
Other ratios			
Return on average assets	3.2%	2.8%	2.7%
Return on average equity	7.7%	9.8%	13.8%
Dividend payout ratio	20.7%	31.8%	40.5%
Valuation measures			
P/E (x)	17.5	17.9	17.1
P/B (x)	1.0	2.1	1.7
Dividend yield	1.2%	1.8%	2.4%

Source: The company

Figure 9. Income statement (RMB m)

	FY12/11	FY12/12	FY12/13
Revenue	**1,562.5**	**1,637.3**	**1,749.9**
Cost for operation	(874.0)	(951.2)	(1,057.6)
Administrative expenses	(104.3)	(105.1)	(108.8)
Financial expenses - net	(196.4)	(212.3)	(177.8)
Other gains and losses	(8.4)	(17.0)	(37.0)
Operating profit	**379.3**	**351.7**	**368.7**
Non-operating gains and losses	(3.3)	21.1	18.8
Profit before taxation	**376.0**	**372.8**	**387.5**
Income tax	(96.2)	(98.2)	(99.2)
Net profit	**279.9**	**274.6**	**288.4**
Net profit attributable to shareholders	275.8	269.0	281.9
Minority interest	4.1	5.6	6.5

Source: The company

Figure 10. Balance sheet (RMB m)

	FY12/11	FY12/12	FY12/13
Non-current assets			
PP&E	2,383.7	3,281.3	3,088.1
Construction in progress	880.9	459.5	1,152.1
Intangible assets	3,254.8	3,191.3	3,074.8
Other	576.5	565.8	484.1
Total non-current Assets	**7,095.9**	**7,497.9**	**7,799.1**
Current assets			
Trade receivables	1,096.6	1,566.7	2,079.1
Prepayments	95.7	120.3	115.7
Cash and bank balances	691.7	1,000.6	1,002.2
Other	105.4	121.4	77.6
Total current assets	**1,989.4**	**2,809.1**	**3,274.6**
Total assets	**9,085.3**	**10,307.0**	**11,073.8**
Current liabilities			
Short-term borrowings	(152.0)	(86.0)	0.0
Advances	(423.4)	(601.4)	(701.7)
Other payables	(412.1)	(511.9)	(537.6)
Other non-current liabilities due within one year	(856.2)	(806.2)	(878.1)
Other	(56.4)	(107.8)	(97.7)
Total current liabilities	**(1,900.1)**	**(2,113.3)**	**(2,215.0)**
Non-current liabilities			
Long-term borrowings	(1,865.0)	(1,931.9)	(1,213.3)
Long-term debentures	(689.9)	(692.0)	(1,384.8)
Deferred revenue	(369.9)	(385.7)	(396.4)
Long-term payables	(386.5)	(350.8)	(291.2)
Other	(158.2)	(900.8)	(1,438.5)
Total non current liabilities	**(3,469.5)**	**(4,261.0)**	**(4,724.2)**
Net assets	**3,715.7**	**3,932.7**	**4,134.5**
Equity			
Share capital	1,427.2	1,427.2	1,427.2
Capital surplus	382.3	382.3	382.3
General reserves	326.2	350.9	373.3
Undistributed profits	1,432.6	1,619.8	1,793.7
Equity attributable to owners of the parent	3,568.3	3,780.2	3,976.5
Minority Interests	147.4	152.4	158.1
Total equity	**3,715.7**	**1,880.8**	**2,285.7**

Source: The company

Figure 11. Cash flow statement (RMB m)

	FY12/11	FY12/12	FY12/13
Operating activities			
Profit before taxation	376.0	372.8	387.5
Adjustment for			
Depreciation, amortisation and provision	254.3	280.4	344.8
Losses/(Gains) on disposals	13.7	(3.2)	4.9
Financial expenses-net	219.2	220.8	192.5
Investment losses/(income)	(0.4)	5.5	3.0
Change in working capital	67.5	(283.9)	(262.0)
Tax paid	(96.2)	(98.2)	(99.2)
Net cash generated from operating activities	**834.2**	**494.2**	**571.5**
Investing activities			
Purchase of PP&E	(626.9)	(659.8)	(743.0)
Net cash received from investment	84.4	774.3	574.1
Cash received from disposal	0.8	21.1	3.9
Nelt cash flow from investing activities	**(542)**	**136**	**(165)**
Financing activities			
Interest paid	(206.1)	(227.5)	(213.7)
Dividends paid	(157)	(28)	(81)
Net repayment of borrowings	(488.8)	(66.2)	(814.0)
Cash received from debenture issuance	689.5	0.0	700.0
Other	19.09	0.00	0.00
Net cash flow from financing activities	**(142.9)**	**(321.9)**	**(408.5)**
Net increase in cash and cash equivalent	149.6	308.0	(2.0)
Cash and cash equivalents at the beginning of the year	539.4	689.0	997.0
Cash and cash equalents at the end of the year	**689.0**	**997.0**	**995.0**

Source: The company

Risks. Major risks include: i) Decrease in water tariff; ii) longer-than expected construction period for BOT projects; iii) failure to obtain new projects from the local government; iv) increase in industry competition, which would lead to decrease in project's IRR and v) increase in interest rate and other financing costs.

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