

More acquisitions expected

China Utilities

China Water Industry (1129 HK, HK\$0.69)

Not Rated

Repositioning. Formerly known as Sky Hawk Computer, China Water Industry Group has been repositioning itself as an integrated water supplier in China, focusing on the supply of drinking water and treatment of sewage. It has recently acquired two water supply projects and two sewage treatment projects and we expect it to dispose of its computer peripheral and watch trading business eventually.

More acquisitions expected. The company is currently negotiating acquisitions of a number of water projects in China. As of end-1H FY12/06F, it was in a net debt position of HK\$5.8m but it raised HK\$109.3m this month through the placement of 230.0m shares at HK\$0.49 each. We expect more fund raising to fund its planned acquisitions, which should serve as the major catalyst for its share price.

Positive FY12/07F outlook. With minimal contributions from its new water business and possible provisions for its loss-making computer peripheral business, we expect weak FY12/06F results. Earnings prospects will improve in FY12/07F, as the water business takes off and the company sheds the computer peripheral operations.

Yichun city project. China Water has acquired 40.0% in Onfar International for HK\$36.0m, which was satisfied by the issue of 180.0m shares at HK\$0.20 each to the vendor. Through this acquisition, it acquired a 20.4% stake in a company in Yichun City, in China's Jiangxi province, which has exclusive rights to supply water and treat wastewater from November 2004 till November 2034 in the city. The company supplies about 90,000 tons of drinking water per day, compared with its designated daily capacity of 160,000 tons. The first phase of its sewage treatment plant, with an annual processing capacity of 14.6m tons per annum, is expected to come on stream between March and April this year. Another revenue source will be the replacement of water meters in the city, which is just about to begin. The company's net profit increased 60.7% YoY to RMB6.0m in FY12/05A. China Water will treat it as an associate for the time being but may increase its stake in the future.

Auhui project. The group has also acquired 100.0% in Dang Shan Water Supply Company (Dang Shan) for HK\$25.0m in cash. Dang Shan used to be a state-owned enterprise supplying drinking water in the downtown area of Dang Shan county, Auhui Province, China, which has a total population of 0.86m and urban population of 0.10m. Dang Shan has a water supply license for 30 years between November 2004 and November 2034 and operates its own pipe network, wells, pumps and other facilities. With the designated daily supply capacity of 30,000 tons, Dang Shan supplies an estimated 10,000 tons of water daily. It has been reorganizing its pipe network to boost the utilization rate and capacity. It has also been negotiating with the local government to obtain rights to operate a sewage treatment plant.

Jinxiang sewage treatment project. China Water has acquired a 70.0% interest in a sewage water treatment plant in Jinxiang county, Jinjing city, China. The county's total population stands at 0.6m and urban population at 0.1m. The Jinxiang government granted the plant a license to build and operate a sewage treatment plant for 29 years from its completion, scheduled for March 2007. The construction will be financed from internal resources and debt. The vendor has also provided a guarantee that the plant's ROE (return on equity) should be no less than 8.0% in FY12/07F, 10.0% in FY12/08F and 11.0% in FY12/09F. Should the plant fail to achieve the target, the vendor will compensate for the difference. The plant will have a designated sewage treatment capacity of 11.0m tons per annum. China Water is also negotiating with the local government a water supply license for the region.

Valuation. The average P/E of Hong Kong-listed China water suppliers is 22.2x for FY07F and 15.6x for FY08F. The share price of China Water Affairs (855HK, HK\$3.75, NR), the company's closest counterpart, has surged more than five-fold YTD. Major risk factors include the execution risk inherent in its expansion/acquisition plan, and unclear track record.

Table 1: Valuations of Chinese water suppliers

Company	Ticker	Year end	Currency	Market cap (US\$m)	P/E (x)	
					1-yr forward	2-yr forward
China Water Affairs Group	855 HK	Mar	HKD	547.7	69.4	25.7
Guangdong Investment	270 HK	Dec	HKD	3,165.0	15.6	14.2
Tianjin Capital Environmental Protection	1065 HK	Dec	HKD	716.9	15.7	13.9
<i>Average</i>					22.2	15.6

Source: Bloomberg