

## China Water Industry: Rising water supplier Andes Cheng (852) 2533 3721 andescheng@softbank.com.hk

**Recommendation: Not Rated**

**China Utilities**

Price	HK\$0.88	Yield (3/06A)	na
12 mth range	HK\$0.06-0.94	ROE (3/06A)	na
Market cap.	US\$157.5m	Net gearing (12/05A)	Net cash
No. shares o/s	1,394.5m	Net cash/sh. (12/05A)	HK\$0.001
Daily t/o, 3 mth	US\$2.1m	BV/sh. (12/05A)	HK\$0.10
Free float %	49%	Consensus EPS	
Major shareholder	Boost Skill Investments Ltd. – 12.9%	- 3/07F	na
Ticker	1129.HK/ 1129 HK	- 3/08F	na

### Key points:

- An emerging water supplier with high potential.
- Acquisitions in the pipeline.
- Unique expansion strategy.
- Set to benefit from the water industry reform.
- Robust demand for water.
- Tariffs to increase further.

**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 sewage treatment. 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 businesses eventually.

**More acquisitions in the pipeline.** The company is searching for new projects in 40 Chinese cities and is currently negotiating water services with in 15 cities. It focuses on medium and small cities with the return on investment of no less than 10.0%. News flows on acquisitions will be one of its major share price catalysts. Under its unique expansion strategy, the company acquires state-owned water suppliers and sewage treatment plants, streamlines their structure and improves their operating efficiency. It also tends to integrate the wastewater treatment and water supply businesses in anticipation that wastewater treatment fees will be included in water tariffs.

**MOU in Shangdong.** In February, China Water Industry entered into a non-legally binding memorandum of understanding (MOU) with the government of Hedong District, Linyi City, and Linyi Water Supply Ltd to set up a water supply joint venture in Linyi City, Shandong province. The company will invest RMB18.0m in cash for a 60.0% stake in the venture. Owned by the Hedong district government, Linyi Water Supply Ltd is principally engaged in the water supply business in Linyi City. Its total asset value is about RMB36.0m and net asset value of RMB30.0m. The current daily capacity of the water plant to be included in the venture stands at 71,400 tons.

**Auhui project.** In 4Q 2006, the company acquired 100.0% of Dang Shan Water Supply Co, a state-owned enterprise supplying drinking water in the downtown area of Dang Shan county, Auhui province, with a total population of 0.86m and urban population of 0.10m. Dang Shan has an exclusive water supply license for 30 years and operates its own pipe network, wells, pumps and other facilities. It supplies an estimated 10,000.0 tons of water daily, compared with its designated daily capacity of 30,000.0 tons. It has been reorganizing its pipe network to boost the utilization rate and capacity and is negotiating with the local government to obtain rights to operate a sewage treatment plant.

**Yichun city project.** In 4Q 2006, the company acquired 40.0% in Onfar International, which directly holds a 51.0% stake in Yichun Water Industry Co. With sole operating rights to supply water and treat wastewater in

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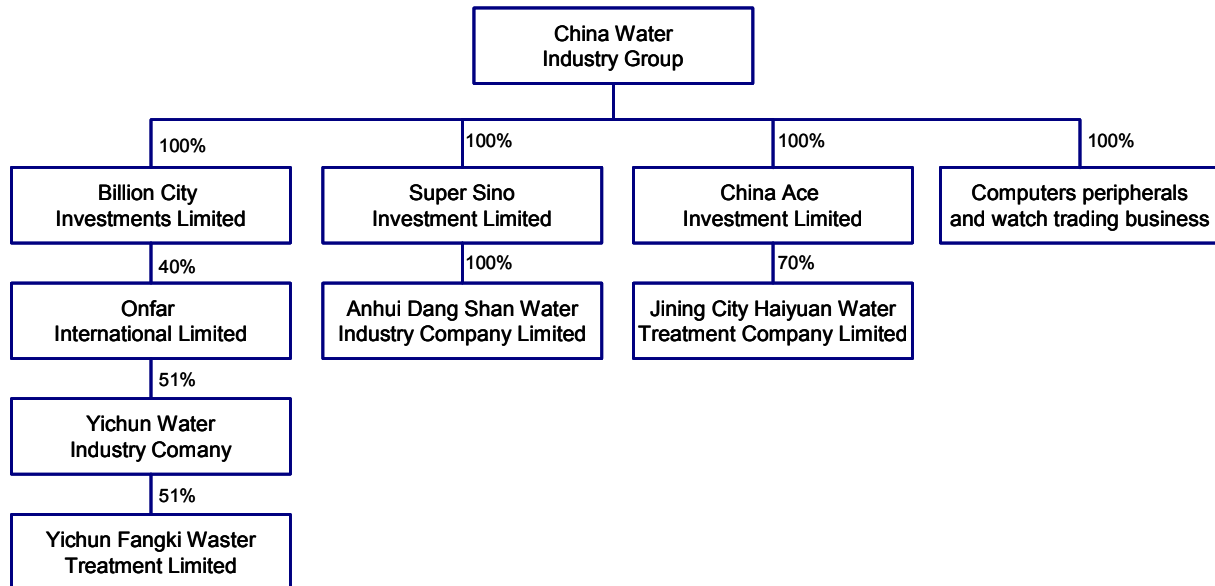
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Yichun City, Jiangxi province, for 30 years, Yichun Water Industry Co, once a state-owned enterprise, was incorporated on June 2005. It supplies about 90,000.0 tons of drinking water per day, compared with its designated daily capacity of 160,000.0 tons. The first phase of its sewage treatment plant, with an annual processing capacity of 14.6m tons, 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. It is noteworthy that the track record of its management team is impressive, with net profit increasing from RMB70,000.0 in FY03A to RMB0.37m in FY04A and to RMB6.0m in FY05A upon restructuring. Since China Water Industry's effective stake in the company is only 20.4%, it will treat Yichun as an associate. However, it may increase its stake in the future.

**Chart 1: Corporate structure**



Source: Company

**Jining City project.** The company also acquired 70.0% in Jining City Haiyuan Water Treatment Co, which has exclusive rights to build and operate a sewage treatment plant in Jinxiang county, Jinjing City, for 29 years. With the total population of 0.6m and urban population of 0.1m, Jinxiang is covered by the national “Bring Water North from South” project and thus subject to stringent pollution controls. The first phase of its water treatment plant, with a designated processing capacity of 11.0m tons per annum, will come on stream in March 2007. It is noteworthy that the vendor has guaranteed the plant’s ROE (return on equity) at at least 8.0% in FY07F, 10.0% in FY08F and 11.0% in FY09F. Should it miss the target, the vendor will compensate for the difference. In order to integrate the water supply and water treatment operations in the district, the company is negotiating with the government the acquisition of water supply rights.

**Water shortage.** With the per capita consumption of 2,200.0 cubic meters per annum, China accounts for 25% the global water consumption per capita. Due to its large population, rapid urbanization and scarce water resources, the country has been plagued by water supply problems, with more than 400 out of its 660 cities suffering water shortages and 110 of them seriously short of water. China consumed 557.3m cubic meters of water in 2005, against its total useable water resources of less than 1,000.0b cubic meters, representing a utilization rate of more than 55.0%. As the population expands and urbanization and industrialization accelerate, demand for water will increase, with consumption expected to reach 700.0b cubic meters by 2030.

**Water industry reform.** In the past, China’s water business was operated by the government and characterized by low economical and operational efficiency. Tariffs were low, even below cost, as water supply was considered an essential welfare service provided by the government. However, the country has been opening the water industry to the private sector due to a number of reasons. Firstly, water supply and treatment is capital intensive, creating a heavy financial burden for the government. Investment in China’s urban water supply system is estimated at RMB143.0b in the next five years, or RMB28.6b per annum. In addition, to boost the wastewater processing rate from the current 52.0% to 72.0% in five years, RMB330.0b and RMB66.0b will be required for wastewater treatment facilities and recycling facilities, respectively. Secondly, the government is encouraging the preservation of water reserves, and a commercialized tariff-setting scheme should be an effective means to encourage rational consumption. Thirdly, the profit-driven private sector will improve the overall efficiency of the water industry. China’s water industry is attractive for the private sector because it is an essential and natural monopolized business within any designated region and a cash cow with stable returns.

**Water pricing reform.** To stabilize in China's water supply and encourage water conservation, the government has been reforming its water tariff system. Between 2000 and 2005, the residential water price increased at a CAGR of 8.9% and integrated water price at 11.6%. The Ministry of Construction plans to charge wastewater processing fees on top of the water price in all cities. To better regulate the water market and prevent wastage, private wells in most of the major cities are forced to close down and water meters are required to be replaced.

**Corporate action.**

- ❑ In October 2006, the group 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.
- ❑ In October 2006, the group acquired 100.0% in Dan Shan Water Supply Company for HK\$25.0m in cash.
- ❑ In December 2006, the group acquired 70.0% in Jining City Haiyuan Water Treatment Company for a consideration of HK\$10.5m.
- ❑ In February 2007, the group raised HK\$109.3m through a placement of 230.0m shares.

**Positive FY07F 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 substantially in FY12/07F, in our view, as the water business takes off and the company sheds its computer peripheral operations. The average P/E of Hong Kong-listed China water suppliers is 22.6x for FY07F and 16.4x for FY08F. The share price of China Water Affairs (855HK, HK\$3.48, 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 China Water Suppliers**

Company	Ticker	Year End	Currency	Market cap (US\$m)	P/E (x)		EV/EBITDA (x)	
					1-yr forward	2-yr forward	1-yr forward	2-yr forward
China Water Affairs Group	855 HK	Mar	HKD	508.3	64.4	23.4	7.9	3.1
Guangdong Investment	270 HK	Dec	HKD	3,250.5	16.0	14.6	8.3	8.0
Tianjin Capital Environmental	1065 HK	Dec	HKD	762.8	15.6	13.8	6.1	5.2
China Everbright International	257 HK	Dec	HKD	685.0	31.1	22.3	5.1	3.7
<i>Average</i>					22.6	16.4	7.5	6.6

Source: Bloomberg

P & L (HK\$m)	03A	04A	05A	Cash Flow (HK\$m)	03A	04A	05A
<b>Year to Mar</b>				<b>Year to Mar</b>			
Turnover	109.4	82.8	61.2	EBIT	8.8	(15.6)	(32.0)
% chg	-	(24.3)	(26.1)	Depre./amort.	9.4	8.3	8.6
Gross profit	32.3	10.6	8.0	Net int. paid	0.3	0.2	2.6
				Tax paid	(0.1)	(0.0)	-
EBITDA	18.2	(7.3)	(23.5)	Dividends received	-	-	-
Depre./amort.	(9.4)	(8.3)	(8.6)	<b>Gross cashflow</b>	<b>18.4</b>	<b>(7.1)</b>	<b>(20.9)</b>
EBIT	8.8	(15.6)	(32.0)	Chgs. in working cap.	(31.5)	5.6	(8.9)
Net int. income/(exp.)	(0.3)	(0.2)	(2.6)	<b>Operating cashflow</b>	<b>(13.1)</b>	<b>(1.5)</b>	<b>(29.7)</b>
Exceptionals	(16.8)	(3.0)	(7.9)	Capex	(1.5)	(3.6)	(6.6)
Associates	-	-	-	<b>Free cashflow</b>	<b>(14.6)</b>	<b>(5.1)</b>	<b>(36.4)</b>
Jointly-controlled entit.	-	-	-	Dividends paid	-	-	-
<b>Pre-tax profit</b>	<b>(8.3)</b>	<b>(18.8)</b>	<b>(42.5)</b>	Net distribution to MI	-	-	-
Tax	(1.3)	0.4	(1.7)	Investments	-	-	(3.5)
Minority interests	-	-	0.1	Disposals	0.1	0.9	3.8
<b>Net profit</b>	<b>(9.5)</b>	<b>(18.4)</b>	<b>(44.2)</b>	New shares	-	9.2	23.5
% chg	-	-	-	Others	6.4	2.0	10.6
Dividends	-	-	-	<b>Net cashflow</b>	<b>(8.1)</b>	<b>7.0</b>	<b>(1.9)</b>
Retained earnings	(9.5)	(18.4)	(44.2)	Net (debt)/cash - Beg.	3.6	(4.5)	2.5
				Net (debt)/cash - End.	(4.5)	2.5	0.6
EPS (HK\$) - Basic	(0.002)	(0.038)	(0.077)	<b>Interim Results (HK\$m)</b>	<b>04A</b>	<b>05A</b>	<b>06A</b>
EPS (HK\$) - F.D.	(0.002)	(0.038)	(0.077)	<b>Six months to Sep</b>			
DPS (HK\$)	-	-	-	Turnover	30.2	24.1	33.5
No. sh.s o/s (m) - W.A.	482.8	482.8	575.9	% chg	(47.2)	(20.1)	38.9
No. sh.s o/s (m) - Y.E.	495.0	495.0	734.5	Profit from operations	3.1	0.3	(21.1)
No. sh.s o/s (m) - F.D.	482.8	482.8	575.9	Interest expenses	(0.1)	(0.1)	(0.3)
				Associates	-	-	-
<b>Margins (%)</b>				Jointly-controlled entit.	-	-	-
Gross	29.5	12.8	13.0	<b>Pre-tax profit</b>	<b>3.0</b>	<b>0.2</b>	<b>(21.4)</b>
EBITDA	16.6	(8.8)	(38.3)	Tax	-	-	-
EBIT	8.0	(18.9)	(52.3)	Minority interests	-	-	0.2
Pre-tax	(7.6)	(22.7)	(69.5)	<b>Net profit</b>	<b>3.0</b>	<b>0.2</b>	<b>(21.2)</b>
Net	(8.7)	(22.2)	(72.2)	% chg	(47.6)	(92.7)	(9,907.9)
				EPS (HK\$) - Basic	0.006	0.000	(0.024)
				DPS (HK\$)	-	-	-
<b>Balance Sheet (HK\$m)</b>	<b>03A</b>	<b>04A</b>	<b>05A</b>	<b>Shareholding Structure</b>		<b>Shares o/s (m)</b>	<b>%</b>
<b>Year to Mar</b>							
Fixed assets	41.1	32.6	21.0	Boost Skill Investments Ltd.		180.0	12.9
Intangible assets	-	2.8	2.2	Favor Jumbo Investments Ltd.		130.2	9.3
Other LT assets	1.3	1.7	-	Sure Ability Ltd.		55.0	3.9
Cash	2.6	5.5	4.5	Wang Chia Chin		20.5	1.5
Accounts receivable	45.7	47.5	48.6	Public		1,008.8	72.3
Other receivables	2.8	-	-	<b>Total</b>		<b>1,394.5</b>	<b>100.0</b>
Inventories	51.8	42.1	44.0				
Due from related co.s	-	-	-	<b>Background</b>			
Other current assets	-	-	0.2	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 sewage treatment. 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 businesses eventually.			
<b>Total assets</b>	<b>145.3</b>	<b>132.1</b>	<b>120.4</b>				
Accounts payable	(14.8)	(24.8)	(27.8)	<b>Key Ratios</b>	<b>03A</b>	<b>04A</b>	<b>05A</b>
Other payable	(9.5)	-	-	Net gearing (%)	4.3	Cash	Cash
Tax payable	(10.5)	(10.4)	(10.5)	Net ROE (%)	(9.2)	(18.6)	(51.8)
Due to related co.s	-	-	-	EBIT ROCE (%)	7.9	(15.1)	(35.7)
ST debts	(7.1)	(3.0)	(3.9)	Dividend payout (%)	-	-	-
Other current liab.	-	-	(0.2)	Effective tax rate (%)	(15.4)	2.2	(4.0)
LT debts	-	-	-	Net interest coverage (x)	32.7	na	na
Other LT liabilities	-	-	(0.5)	A/R turnover (days)	152.4	205.3	286.5
<b>Total liabilities</b>	<b>(41.8)</b>	<b>(38.2)</b>	<b>(42.9)</b>	A/P turnover (days)	49.4	87.2	156.7
Share capital	41.5	49.5	73.5	Stock turnover (days)	245.3	237.3	295.0
Reserves	62.0	44.4	3.1				
<b>Shareholders' funds</b>	<b>103.5</b>	<b>93.9</b>	<b>76.6</b>				
Minority interest	-	-	2.0				
<b>Total</b>	<b>103.5</b>	<b>93.9</b>	<b>78.6</b>				
Capital employed	110.6	96.9	82.5				
Net (debt)/cash	(4.5)	2.5	0.6				