

China State Const.



Building on emerging markets

Not Rated

Key points:

- Leading civil infrastructure and engineering contractor with projects in Macau, UAE, India and China
- Over 30 years in business
- Contracts on hand worth HK\$40.0b
- Foray into infrastructure and land development investment in China
- Trading at 10.1x FY12/08F and 8.2x FY12/09F P/E fully diluted

Asia Pacific Construction

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Stock data

Price	HK\$1.86
12 mth range	HK\$1.94-4.33
Market cap.	US\$587.3m
No. shares o/s	2438.4m
Daily t/o, 3 mth	US\$2.8m
Free float %	38.0%
Major shareholder	CSCEC-62.0%
Ticker	3311.HK/3311 HK

Company background. China State Construction (CSCEC) is an integrated engineering construction contractor and project management company. For over 30 years, the company has been engaged in civil infrastructure projects in Hong Kong. It has recently entered the emerging markets of India and the UAE (Dubai). The company was spun-off in Jul 2005 after parent China Overseas Land & Investment's (688 HK) restructuring with parent group China Overseas Holdings Ltd (COHL).

Financial summary

Year to Dec	07A
Yield (%)	3.7
ROE (%)	25.9
Net gearing (%)	Cash
Net debt/sh. (HK\$)	Cash
BV/sh. (HK\$)	0.89
Consensus EPS (HK\$)	
- 12/08F	0.223
- 12/09F	0.275

Proven track record. A testimony to its superb construction management ability, CSCEC's more than 700 completed construction projects include passenger terminal buildings of the Hong Kong International Airport and Guangzhou Baiyun International Airport, Disneyland Hong Kong's infrastructure and buildings, Hong Kong's MTR station at Tseung Kwan O and Tunnels and Macau's Wynn Resorts.

Table 1: Selected projects completed by CSCEC

Projects completed	Period	Client	Value (HK\$m)
Hong Kong Int'l Airport Passenger Terminal *	1995-97	HKSAR Gov.	10,100
Guangzhou Baiyun Int'l Airport Passenger Terminal	2001-03	Guaug. Baiyun Int'l Airport Co.	174
Infrastructure for Penny's Bay Development **	2001-06	HKSAR Gov.	3,468
Wynn Resorts Macau	2004-06	Wynns Resorts	1,993
Hong Kong Disneyland (various projects) ***	2003-05	Disneyland	856
Dubai Mall Hotel	2005-Pres	Emaar Propoerties	1,550

* Contract awarded to a JV consortium (CSCEC had 20% interest)

** Penny's Bay Development is the site for the Hong Kong Disneyland

*** 1) HK Disneyland Hotel and 2) Space Mountain and Buzz Lightyear rides

Source: Company data

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Market share and scale. CSCEC is comparable to other leading international contractors such as Dragage, Skanska and Leighton in terms of size, scale and ability. Management estimates that the company is the largest engineering contractor in its core market of Hong Kong, with around 15% of the market, and its wholly-owned China Construction Engineering (Macau) Ltd is the largest engineering contractor in Macau. Unlike other engineering companies in China, the company has a diversified management team with more than 3,500 staff from 18 countries. In each of its operating regions, CSCEC holds the highest level licences, allowing it to bid for and participate in the largest scale projects offered. In Hong Kong, the company is one of only four engineering contractors with "Group C" licences (the highest) in the five major construction categories.

Table 2: Staff breakdown (by nationality)

Country of origin	%
China	49.9
Hong Kong	42.2
Middle East	4.2
Other Asian countries	3.2
Europe, North America, Australia	0.3
Africa	0.2
Total	100.0

Source: Company data

New markets and businesses. Since its Jul 2005 listing, CSCEC leveraged its leading market position, strong experience and track record in Hong Kong to diversify into growth markets such as Dubai, India, Macau and China. It won its first projects in Dubai and India in 2005 and entered the Macau market in May 2006 via the acquisition of China Construction Engineering (Macau) from parent COHL. In Jul 2007, it acquired more assets from COHL, including Shenzhen China Overseas Construction Ltd (SCOCL). In Nov 2007, it acquired from COHL China Overseas Infrastructure Holdings Ltd (COIHL) to enter infrastructure investment. COIHL's principal business is the production and supply of heat, electricity and steam in Shenyang, Liaoning province. This foray into infrastructure operations and management (O&M) is a natural move in our view, offering high synergies between infrastructure construction and O&M.

Table 3: Acquisitions since listing

Acquisition	Timing	Consideration	Remarks
China Construction Engineering (Macau) Co. Ltd. (CCEM)	May 2006	HK\$86.2m	Largest building and civil infrastructure engineering contractor in Macau, with over 20 years history
China Overseas Insurance Ltd. (COIL) and China Overseas Insurance Services Ltd. (COISL)	July 2007	HK\$393.0m	Provision of construction insurance services
COHL (Macau) Commercial and Industrial Com. Ltd. (COHL Macau)	July 2007	HK\$100.0m	Provision of construction insurance services in Macau
Shenzhen China Overseas Construction Ltd. (SCOCL)	July 2007	HK\$17.0m	Building construction contractor in China
China Overseas Public Utility Investment Ltd. (COPUIL)	Nov 2007	HK\$400.0m	Production and supply of heat, electricity and steam in Shenyang, Liaoning Province

Source: Company data

Successful diversification. We like CSCEC's diversification strategy, which spreads the risk across multiple markets and creates long-term growth drivers. We also like its choice of relatively politically stable and transparent markets. The infrastructure investment foray should raise the company's ROE in the long term and provide a source of recurring income. We expect CSCEC diversification efforts to continue, with the broadening of its Dubai operations to adjacent Abu Dhabi and purchases of other infrastructure investment assets (with an IRR of not less than 12%) from its parent. CSCEC has reduced its reliance on the Hong Kong market from 100.0% of revenue in FY12/05A to 54.1% in FY12/07A.

Table 4: Revenue breakdown (by region)

Year to Dec (%)	05A	06A	07A
Hong Kong	100.0	72.9	54.1
China (ex. HK and Macau)	-	-	6.5
Macau	-	14.9	15.6
Dubai	-	7.7	20.3
India	-	4.4	3.5
Total	100.0	100.0	100.0

Source: Company data

Revenue breakdown. The company derives its revenue mainly from: 1) construction (construction contracts and project management services); 2) infrastructure investment and 3) others (sales of precast structures, building materials, machinery leasing). At the end of FY12/07A, construction revenue accounted for 95.8% of CSCEC's total of HK\$10,168.3m, down from FY12/06A of HK\$10,294.8m due to a change in the nature of its "City of Dreams" JV contract in Macau (from construction to management project), which meant only a management fee was recognized. Gross profit grew a healthy 66.9% YoY to HK\$766.1m, aided by maiden contribution from its infrastructure investment segment.

Table 5: Revenue breakdown (by segment)

Year to Dec (HK\$m)	05A	%	06A	%	07A	%
Construction revenues	6,839.4	(19.1)	10,231.5	49.6	9,739.1	(4.8)
Infrastructure investment	-	-	-	-	302.4	-
Others	23.1	29.5	63.4	174.1	126.8	100.2
Total	6,862.5	(19.0)	10,294.8	50.0	10,168.3	(1.2)
Gross profit	331.1	(8.7)	459.1	38.6	766.1	66.9

Source: Company data

Track record of new projects. CSCEC's projects totaled HK\$12.0b in FY12/05A, HK\$14.2b in FY12/06A and HK\$11.2b in FY12/07A. In the first five months of FY12/08, the company secured around HK\$6.0b in new contracts. Currently, CSCEC has around HK\$40.0b contract on hand (CoH).

Table 6: New contracts awarded

Year to Dec (HK\$m)	05A	06A	07A	1-5M	08A
Hong Kong	5.96	4.55	5.16		5.00
China (ex. HK and Macau)	0.96	0.06	0.15		1.00
Macau	1.30	7.99	3.78		-
Dubai	2.22	1.56	2.10		-
India	1.55	-	-		-
Total	11.99	14.16	11.19		6.00

Source: Company data

Bright prospects in all markets. Hong Kong's Chief Executive has announced 10 infrastructure initiatives to boost the local economy such as MTRC's South Island Line (worth >HK\$7.0b) and the West Kowloon Cultural District. In addition to casinos and hotels, Macau plans a series of large-scale infrastructure projects, including an extension of the Macau International Airport, cross harbour tunnels and land reclamation projects. Dubai is expected to award HK\$700b in construction contracts in the next five years.

Mitigating raw material price increases. One of key strengths of CSCEC is its ability to mitigate the impact of raw material price increases. About 40.0% of its CoH are government projects, which have raw material price adjustment factors built into contract terms. Another 30.0% are either cost-plus contracts (which can fully transfer raw material price increases), or project management service contracts (independent of raw material prices). For the remaining 30.0%, CSCEC adopts ways to hedge against price hike risks, such as: 1) pre-billing analysis and sourcing from multiple suppliers; 2) locking in prices at the beginning of contracts and 3) innovative construction techniques and management.

Diversification into land development. In Dec 2007, the company announced that it would set up a land development JV, 60.0%-owned by SCOCL and 40.0% by Tianjin Binhai. Under the agreement, State-owned Tianjin Binhai will be responsible for land acquisitions, while CSCEC will inject working capital and have a right to participate in the sites' basic infrastructure and utility construction. Once this is in place,

the sites will be sold in the open market through auction. CSCEC's income will be in the form of investment development profit.

Shareholding structure. CSCEC's largest shareholder is China State Construction Engineering Corp, with a 62.0% stake. Fidelity International, the next largest shareholder, has 4.8%.

Corporate actions and fund raising. Deloitte has been the company's auditor since listing. In May 2008, the company announced a sub-division of four shares for every existing share. In Jan 2008, it announced a bonus issue of warrants to existing shareholders to the effect of one warrant for every seven shares held. The warrants have a subscription price of HK\$3.75 and will expire on 27 Feb 2009. They carry rights to subscribe for a total of 348.2m new shares, representing 14.3% of the company's existing share capital and 12.5% of its enlarged share capital.

Valuation. The counter is currently trading at 10.1x FY12/08F and 8.2x FY12/09F P/E fully diluted (assuming full exercise of all warrants and options) according to consensus estimates, compared to an average of 16.8x current-year forward and 14.4x one-year forward P/E for peers in developed countries and 22.2x and 15.4x for peers in emerging countries.

Risks: 1) Significant global economic slowdown affecting the emerging markets; 2) execution risks in new emerging markets.

Table 7: P&L

Year to Dec (HK\$m)	05A	06A	07A
Revenue	6,862.5	10,294.8	10,168.3
Contract costs	(6,531.4)	(9,835.8)	(9,089.6)
Other operating costs			(312.6)
Gross profit	331.1	459.1	766.1
Net investment income		64.5	99.7
Other income	45.2	13.3	30.2
Administrative expenses	(169.1)	(249.7)	(332.0)
Selling and distribution expenses	(3.6)	(4.8)	(10.7)
Other expenses	(20.9)	(16.5)	(30.0)
Share of results from associates	4.4	6.9	8.8
Finance costs	(10.2)	(1.6)	(1.8)
Profit before tax	176.9	271.0	530.3
Tax	(30.3)	(49.2)	(82.4)
Profit after tax	146.5	221.9	448.0
Minority interest	(15.9)	0.3	(43.1)
Net profit	130.7	222.2	404.9

Source: Company data

Table 8: Margin trend

Year end Dec (%)	05A	06A	07A
Gross	4.8	4.5	7.5
Net	1.9	2.2	4.0

Source: Company data

Table 9: Key ratios

Year to Dec	05A	06A	07A
Inventory days	n/a	n/a	n/a
Receivable days	106.7	86.1	108.1
Payables days	146.7	114.5	144.6
Current ratio (x)	1.2	1.2	1.2
Gearing (%)	Cash	Cash	Cash
ROE (%)	13.4	24.5	25.9
Debt/equity (%)	0.3	1.6	3.2
Interest coverage (x)	18.3	175.5	291.9

Source: Company data

Table 10: Peer comparison

Company name	Ticker	Mkt Cap (US\$m)	Last Price (Local)	HIS P/E (x)	Curr-yr Fwd P/E (x)	Nxt-yr Fwd P/E (x)	ROE (%)
<u>Developed countries</u>							
Leighton Holdings	LEI AU	13,380.9	50.75	31.2	23.4	19.6	36.7
United Group	UGL AU	1,803.0	11.66	17.0	13.7	11.6	16.6
Transfield Services	TSE AU	1,375.7	7.52	21.8	13.5	10.8	21.9
Balfour Beatty	BBY LN	4,066.9	439.75	11.1	11.3	10.4	34.7
AMEC	AMEC LN	6,103.1	950.50	25.5	24.2	19.8	48.5
Skanska	SKAB SS	6,144.6	91.00	8.5	9.2	9.2	50.6
KBR	KBR US	6,156.5	35.99	24.9	22.4	19.4	14.9
<i>Average</i>				<i>20.0</i>	<i>16.8</i>	<i>14.4</i>	<i>32.0</i>
<u>Emerging countries</u>							
China Railway Construction	1186 HK	17,053.2	11.38	35.1	27.9	19.2	59.8
China Railway Group	0390 HK	16,024.9	6.10	29.5	28.7	18.9	7.8
China Communications Const.	1800 HK	27,574.7	14.72	31.2	22.2	15.2	15.7
Nagarjuna Construction	NJCC IN	835.5	168.85	20.2	15.7	11.8	9.8
Hindustan Construciton	HCC IN	612.9	108.90	29.6	16.6	11.9	9.8
<i>Average</i>				<i>29.1</i>	<i>22.2</i>	<i>15.4</i>	<i>10.8*</i>
China State Construction	3311 HK	572.1	1.86	16.4	10.1	8.2	18.7

* Excludes China Railway Construction (390 HK)

Source: Company data