China State Const'n

Tue, 18 Aug 2009

Ramping up China

BUY (unchanged)

Ticker:	**3311.HK**	12 mth range:	HK$0.57-4.05
Price:	**HK$3.38**	Market cap:	US$1,274.5m
Target:	**HK$3.77 (+12%)**	Daily t/o, 3 mth:	US$6.1m
		Free float %:	31.0%

Financial summary

Year to Dec	07A	08A	09F	10F	11F
Turnover (HK$m)	10,168.3	11,021.4	11,503.5	14,511.6	17,879.2
Net Profit (HK$m)	404.9	489.3	571.1	712.4	895.4
EPS (HK$)	0.172	0.192	0.219	0.242	0.305
EPS Δ%	62.1	11.6	13.9	10.9	25.7
P/E (x)	18.4	16.8	14.5	13.9	11.1
P/B (x)	3.81	3.28	2.56	3.06	3.18
EV/EBITDA (x)	14.6	12.3	11.1	11.2	10.2
Yield (%)	1.4	2.4	2.1	2.2	2.7
ROE (%)	25.9	20.9	17.8	20.0	28.1
ROCE (%)	28.2	20.4	14.8	17.8	23.4
N. Gear. (%)	Cash	Cash	Cash	Cash	30.3

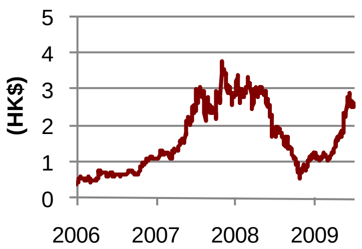
Source: Company data and SBI E2-Capital

Price Performance

	1 mth	3 mth	12 mth
Relative to HSI (%)	+3.5	+44.5	+134.0
Actual price changes (%)	+11.1	+71.5	+125.8

	09F	10F	11F
Consensus EPS (HK$)	0.223	0.259	0.320
Previous forecasts (HK$m)	544.4	638.5	759.9
Previous EPS (HK$)	0.222	0.261	0.310

Price Chart



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Key points:

- 1H net profit up 17.9% YoY to HK$303.4m, above our expectations. Strong bottom line growth due to: 1) better than expected gross margin; 2) solid administrative cost control and 3) lower than expected effective tax rate
- China and Hong Kong markets emerging to drive CSCI top and bottom line growth
- CSCI has been successful in securing two BT projects in China and has also partnered with SOEs CCCC (1800 HK) and CMC to tap China's investment fund/financial aid to ally emerging countries
- Other core markets positive long term. Abu Dhabi continues to see investment projects being put out for tender while we expect Macau and India to see more opportunities in 2010
- CSCI has announced a 1 for 5 existing rights issue at HK$2.79. Parent COHL has fully underwritten the subscription. The net proceeds of HK$1,351.5m would be used for working capital
- We revised up our earnings estimate to HK$571.1m (from HK$544.4m) for FY12/09F and to HK$712.4m (from HK$638.5m) for FY12/10F
- Maintain BUY call on the counter with new DCF-derived target price HK$3.77, representing 15.5x FY12/10F P/E

Better margins drives 1H surprise. CSCI announced 1H FY12/09A results with revenue up 1.7% YoY to HK$5,502.0m and net profit up 17.9% YoY to HK$303.4m. Blended gross margin of 8.4% was up 1.0pcp. The results surprised on the upside overall. While the company booked less revenue than expected, it's: 1) better than expected gross margin; 2) good control of administrative expenses and 3) lower than expected effective tax rate (9.4% vs SBI E2 estimate 15.0%) provided the base for the upside earnings surprise.

Segment details. In terms of geographical segments, Hong Kong revenue was up 18.0% YoY to HK$3,352.4m while China revenue surged 114.3% YoY to HK$616.1m, boosted by maiden contribution from the two toll bridge operations (infrastructure investment) in Nanchang. Infrastructure investment accounted for 35.9% of China revenue. Impacted by global credit crisis in 2008/early 2009 and/or completing contracts, Macau revenue dropped 30.3% YoY, UAE (primarily Dubai) shrank 29.7% YoY and no revenue was booked in India. The result is indicative of CSCI's geographical diversity advantages where the company can maintain a sustainable rate of growth despite weakness in some geographical segments. Over the past two years, the company's revenue drivers has shifted to Hong Kong and China. Between 2005-2007, the company's key drivers were Macau, Dubai and India.

Margin discussion. Hong Kong was able to enhance its gross margin by 0.8pcp YoY to 4.9% from better pricing from contracts secured in late 2008 and retreat in raw material prices. Gross margin fell 3.1pcp YoY to 26.9% in China mainly due to shift in revenue mix (construction accounting for a higher proportion of revenue). Management commented that they were able to secure a tariff increase for its Heating Plant in Huanggu, Shenyang. As expected, gross margin for the UAE market dropped 1.4pcp YoY to 4.2% given the lower revenue contribution. However, gross margin in Macau increased 1.2pcp YoY to 12.2%, and higher than other geographical segments, despite the tighter operating conditions mainly due to contribution from the City of Dreams contract, a project management contract, which typically carries higher margins as CSCI is not responsible for the raw material procurement and construction.

Table 1: Segment breakdown

Year end Dec (HK$m)	Revenue	YoY chg (%)	Gross Margin (%)	YoY chg (pcp)
Hong Kong	3,352.4	18.0	4.9	0.8
China * (ex. Hong Kong)	616.1	93.1	26.9	(3.1)
Macau	889.4	(30.3)	12.2	1.2
UAE	664.1	(29.7)	4.2	-1.4
India	-	(100.0)	-	-
Total	**5,502.0**	**1.7**	**8.4**	**1.0**

Source: Company data

* *Includes infrastructure investment revenue*

Table 2: Segment contribution

	Revenue		Gross Profit	
Year end Dec (HK$m)	1H 09 %	1H 08 %	1H 09 %	1H 08 %
Hong Kong	60.9	52.6	35.0	29.4
China * (ex. Hong Kong)	11.2	5.3	35.7	21.7
Macau	16.2	23.6	23.3	35.0
UAE	12.1	17.5	6.0	13.1
India	-	1.1	-	0.8
Total	**100.0**	**100.0**	**100.0**	**100.0**

Source: Company data

* *Includes infrastructure investment revenue*

China and Hong Kong to be main focus near term. The company's focus over the near term will undoubtedly be the China and Hong Kong geographical markets. In China, the company has secured two build-transfer (BT) projects (see Table 3) since announcing in Apr 2009 their intention to enter China's infrastructure market. Management has indicated that it is continuing talks with several other potential projects. Company is targeting BT projects with an IRR of not less than 20%. While this is an aggressive target, we think this is a more suitable strategy as it forces the company to be more selective in its China infrastructure projects and its synergies with parent CSCECL should allow it to have a slight negotiation advantage relative to its peers. Meanwhile in Hong Kong, contract packages for the "10 Mega Projects" have started being tendered and we expect the pace of tender to accelerate towards the end of 2009 and going into 1H 2010. In addition, there will be other mid to large scale infrastructure and building projects to be let out by the government. We expect CSCI, Hong Kong's market leader with around 10-15% market share to secure its share of the contract packages. The Hong Kong government has announced a HK$39.3b infrastructure spending budget for the government's fiscal year 2009-2010 and we expect this to further increase in fiscal year 2010-2011.

Table 3: Profile of BT projects

Project	Brief Profile	CSCI Interest	JV Partners	Total Est. Cost
Tangshan Binhai Avenue	39.2km expressway from Seaport Development Zone to Caofeidian	50.0	CSCECL	RMB3,200-4,000m
Wuxian Highway	Reconstruction of Wuxian Highway and Construction of Shahu Passageway. Wuxian Highway is about 7.5km including 7.2km viaduct section. Shahu Passageway is about 2.6km	30.0	CSCECL, CCTEB	RMB2,600m

Source: Company data

Other core markets positive long term. We remain positive on CSCI's other core markets long term despite some near term challenges. In India, we think infrastructure and building investment would begin to pick up progressively after the recent elections. Our channel checks suggest that international engineering consultants are beginning to increase their presence, which is usually a signal for an impending acceleration in construction activities. The situation is similar in Macau, where we expect government fiscal stimulus activities to pick up after the new Chief Executive comes into power later this year. Meanwhile, in UAE, though Dubai is facing some difficulties at present, other UAE member states, such as Abu Dhabi and Qatar have remained steady. Leighton Holdings (LEI AU) CFO at their recent 3Q conference call remarked that while construction investment in Abu Dhabi has been scaled back, they remain ambitious and there is a steady stream of projects being let out for tender. This should

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bode well for CSCI in the UAE region as the company has spent the past two years establishing their presence in Abu Dhabi.

Further opportunities to tap Chinese government funding. The Chinese government has set aside a US$10.0b in investment funding and financial aid to help partner emerging countries and also encourage the "going out" policy of Chinese countries. To this effect, the company has signed separate cooperation agreements with China Road & Bridge Corporation (CRBC), a subsidiary of **China Communications Construction (1800 HK)** and China National Machinery Import & Export Corporation (CMC) to jointly secure engineering-procurement-construction (EPC) contracts in such emerging countries and capture a slice of the fund. In our view, risk is not high, since CSCI: 1) has experience in establishing presence in new geographic markets; 2) is partnering with large scale SOEs and 3) contracts are likely to be secured through negotiations rather than open tender, which would likely result in slightly higher margins.

New contracts and backlog. To date in 2009, CSCI has secured HK$11.1b in new contracts. It currently has in-hand contract value amounting to HK$44.9b and contract backlog of HK$25.3b.

Table 4: New contracts awarded

(HK$b)	1H 08	2008	1H 09	2009 To Date
Hong Kong	5.43	9.48	4.40	6.87
Macau	1.48	1.62	-	-
UAE	-	1.82	-	-
India	-	-	-	0.33
Mainland China	0.72	1.26	3.14	3.94
Total	**7.63**	**14.18**	**7.54**	**11.14**

Source: Company data

Table 5: Project in progress

	1H 08		1H 09		2009 To Date	
(HK$b)	Contract Value	Backlog	Contract Value	Backlog	Contract Value	Backlog
Hong Kong	19.32	11.98	23.29	12.74	25.76	14.55
Macau	12.00	9.24	10.43	3.57	9.73	3.35
UAE	5.27	2.54	6.14	2.75	6.14	2.65
India	0.30	0.06	-	-	0.33	0.33
Mainland China	1.11	0.67	4.08	3.71	4.87	4.43
Total	**38.00**	**24.49**	**43.94**	**22.77**	**44.90**	**25.31**

Source: Company data

Capex. Company maintained its capex plan at HK$600m for FY12/09A (HK$400m for BT projects). For 1H FY12/09A, company invested around HK$170m on capex (28.3% of total).

1 for existing 5 rights issue proposed. CSCI announced a proposed 1 rights share for every 5 existing shares rights issue at HK$2.79 on 16 Jul 2009. Parent company China Overseas Holdings Limited (COHL) has agreed to fully underwrite all of the rights shares. The net proceed of not less than HK$1,351.5m would be used as working capital as the company secures more construction and BT projects. The rights issue is expected to be completed by early Sep.

Raising target price to HK$3.77, maintain BUY call. We revised up our net profit estimate for FY12/09F to HK$571.1m (from HK$544.4m) and for FY12/10F to HK$712.4m (from HK$638.5m) based increased contribution from BT contract from Mainland China and better gross margin for Hong Kong. Our updated DCF-derived target price is HK$3.77 with WACC of 11.3% and terminal growth of 2%, representing 15.5x FY12/10F P/E (right issue effect has been fully considered). Maintain BUY.

Table 6: DCF valuation reference table

			Terminal Growth		
WACC	1.0%	2.0%	3.0%	4.0%	5.0%
9.3%	4.52	4.94	5.49	6.25	7.37
11.3%	3.53	3.77	4.06	4.44	4.93
13.3%	2.85	2.98	3.14	3.33	3.56
14.3%	2.59	2.70	2.82	2.97	3.15

Source: SBI E2-Capital

Table 7: P & L

Year to Dec (HK$m)	07A	08A	09F	10F	11F
Turnover	10,168.3	11,021.4	11,503.5	14,511.6	17,879.2
Cost of sales	(9,402.2)	(10,112.0)	(10,522.5)	(13,294.6)	(16,396.6)
Gross profit	766.1	909.4	981.0	1,217.0	1,482.6
Other income	129.9	71.3	78.3	63.5	58.6
Selling and distribution costs	(10.7)	(17.8)	(21.8)	(21.1)	(25.1)
Administrative expenses	(332.0)	(394.0)	(369.2)	(422.2)	(456.0)
Other expenses	(29.9)	12.5	(7.1)	(4.4)	(5.4)
Operating profit	523.3	581.3	661.2	832.8	1,054.8
Financial costs	(1.8)	(20.1)	(18.3)	(26.0)	(33.8)
Share of loss of a jointly controlled entity					
Share of loss of an associate	8.8	9.4	7.1	7.8	8.2
Pre-tax profit	530.3	570.7	650.0	814.6	1,029.2
Tax	(82.4)	(66.3)	(78.9)	(102.2)	(133.8)
Minority interests	(43.1)	(15.1)	-	-	-
Net profit	404.9	489.3	571.1	712.4	895.4

Source: Company data and SBI E2-Capital