

Post results sector recap

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Key points:

- * HK-listed railway construction players have all announced FY12/08A earnings
- * MoR plans to invest RMB600b in 2009 for railway infrastructure. CRG and CRC accounted for around 80% of the railway construction market
- * We provide summaries and latest developments for China Railway Group (390 HK), China Railway Construction (1186 HK), China Communication Construction (1800 HK)
- * The sector has been hot since the end of 2008 benefiting from the heavy government investment in railway construction
- * CCC is currently trading at 15.5x, CRG 18.0x, CRC 19.4x FY12/09F P/E based on consensus. We think the sector as a whole is fairly value. Potential upside would come from: 1) announcements of a second stimulus package by the government; 2) any news relating to strong loan growth in the construction industry. Downside risk would come from: 1) project execution delays; 2) delays in funding or approval of new railway projects
- * We think a laggard for this sector is CSCI (3311 HK). The company recently announced that they have entered into a sub-construction engagement agreement with parent CSCECL to participate in infrastructure construction in China. Subsequently, it has also formed a JV with CSCECL to tender for infrastructure projects in China. Counter is currently trading at 7.9x FY12/09F P/E on consensus

Earnings announced by sector players. HK-listed railway construction players have all announced their FY12/08A results. MoR plans to invest RMB600b for railway infrastructure in 2009. In the report, we summarise the recent results and key developments of the following companies: China Railway Group (390 HK), China Railway Construction (1186 HK) and China Communication Construction (1800 HK).

China Railway Group (390 HK, HK\$5.35)

China Railway Group (CRG) announced FY12/08A results on 29 Apr 2008. Revenue increased 26.8% YoY to RMB225.1b and net profit down 45.7% YoY to RMB1.4b (incl. forex loss of RMB4.1b). The gross margin was up 0.1 pcp YoY to 7.3%. For IQ FY12/09A, revenue was up 70.9% to RMB60.1b and net profit increased 86.6% YoY to RMB1.0b. Infrastructure construction is still the main revenue contributor of the company, accounting for 90.1% of total revenue(pre-elimination). CRG had backlog contract of RMB411.6b at the end of FY12/08 with a new contract value of RMB130b for IQ FY12/09.

- Infrastructure construction revenues increased 20.6% YoY to RMB203.3b with operating profit up 126.2% YoY to 4.4b. The operating margin was up 1.0 pcp YoY to 2.2%. The management is still very positive on the development of this segment from national railway and city railway construction. Management said that CRG's railway market share was approximately 43%. The backlog contract increased 93.8% YoY to RMB399.2b at the end of 2008.
- Revenue of survey, design and consulting services segment increased 28.3% YoY to RMB4.4b with operating profit up 111.1% YoY to RMB494.0m. The operating margin was up 4.4 pcp to 11.3%. The backlog contract increased 12.2% YoY to RMB6.8b at the end of 2008.
- Engineering equipment and component manufacturing revenue was up 33.7% YoY to RMB6.9b, with operating profit up 363.7% to RMB779.0m. The operating margin was up 8.0 pcp YoY to 11.2%. The backlog contract increase 26.9% YoY to RMB5.5b at the end of 2008.
- The property segment sales were up 15.9% YoY to RMB3.8b with operating profit up 12.7% YoY to RMB566.0m. The operating margin was down 0.4 pcp YoY to 14.9%. The economy slow down has effect the growth and margin although CRG has relative land cost advantage. The management's revenue target is RMB4.0b for FY12/09 with about 10% operating margin.
- The revenue of other business was up 31.7% YoY to RMB10.7b with operating profit down 25.1% YoY to RMB477m. The margin squeezed 3.3pcp YoY to 4.5%. The margin was mainly affected by the loss from BOT project started in 2008.
- Management expects gross margin in 2009 to slightly trend up one a combination of: 1) raw material price decrease; 2) improving cost management; 3) bulk sourcing of material and equipment; 4) some railway contracts

restructured, whose benefits will come in 2009. However, it is difficult to apportion exact magnitude of rise in each segment.

- In Nov 2008, CRG acquired 52%, 51% and 51% of Inner Mongolia Huaxin mining, Sunite-zuo QiManglai mining and Sunite-ZuoQi Xiaobaiyang mining for RMB469.0m cash. Management expects the mining business will achieve strong growth in 2009
- The capex for 2009 would be RMB13.1b, mainly for purchasing equipment for infrastructure construction.
- CRG plans to acquire ports and dredging related company for 2009 to diversify its construction portfolio.

China Railway Construction (1186 HK, HK\$10.80)

China Railway Construction (CRC) announced FY12/08A results announced on 18 Apr 2008. CRC's revenue was up 27.6% YoY to RMB219.5b with net profit up 58.4% YoY to RMB3.6b (incl. forex loss of RMB0.8b). Gross margin was up 0.6pcp YoY to 7.2%. For IQ FY12/09A, revenue increased 56.1% YoY to RMB51.3b while the net profit increased 33.9% YoY to RMB0.9b. Infrastructure construction accounted for 91.6% of total revenue(pre-elimination). CRC had contract backlog of RMB471.1b at the end of FY12/08A with new contract of RMB127.8b for IQ FY12/09A.

- For FY12/09F, management is targeting a 20%+ YoY revenue growth, mainly driven by the railway business. CRC accounted for 40%+ railway construction market.
- CRC failed to achieve the original target of 0.6-0.7pcp net margin expansion. Actual improvement for FY12/08A was 0.4pcp or 0.5 pcp (excl. forex loss effect). Management explains that it mainly affected by: 1) increased raw material price; 2) increased labour cost; and 3) unexpected natural disaster.
- The management indicated that they are positive on the development of its non-infrastructure construction business. In particular, they would expect 50%+ growth in railway maintenance equipment manufacturing.
- The overseas business accounted for around 7.8% of CRC's total revenue for FY12/08A. For IQ FY12/09A, CRC secured around RMB28.0b new overseas contracts, accounting for 21.9% of total new signings. The projects are mainly in Saudi Arabia, Nigeria and Liberia.
- Although MOR has allowed non-railway companies to participate in railway construction, management think that it would not affect the current operation of the company for the coming 3 years, given: 1) MOR only give 20% market share to non-railway company; 2) the large investment in railway construction sector.
- The capex for 2009 would be around RMB10b. CRC currently has net cash of RMB39.0b.

China Communications Construction (1800 HK, HK\$9.34)

China Communications Construction (CCC) revenue up 18.8% YoY to RMB178.9b and net profit up 0.7% YoY to RMB6.1b. Gross margin narrowed 0.3 pcp YoY to 10.0% with net margin down 0.6 pcp YoY to 3.4%. The gross margin squeeze was affected by: 1) subcontracting costs; 2) increased raw material cost; 3) increased finance cost.

- For infrastructure construction segment, revenue increased 20.1% YoY to RMB122.1b with operating profit up 12.9% YoY to RMB4.9b. Gross margin up 0.1 pcp YoY to 7.3% with operating margin down 0.2 pcp YoY to 4.0%. Margins was mainly dragged down by increased R&D expenses in several of its subsidiaries to gain high tech company tax concession. Margin has seen some recovery in 4Q FY12/08. In FY12/09F, the margin is expected to improve because of raw material cost decrease and better cost control. The railway related business accounted for about 9.0% of total infrastructure construction revenue.
- For dredging segment, the revenue increased 30.5% YoY to RMB19.0b with operating profit up 17.1% YoY to RMB2.2b. Gross margin was down 3.4 pcp YoY to 14.3% with operating margin drop 1.3 pcp YoY to 11.7%. Though margins in 2H were improved, management was still disappointed with overall results. They cited increased proportion of outsourced work and several large scale projects lost money due to external factors. For the latter, company is currently negotiating for variations in the contract. Management expects significant improvement in 2009.
- For infrastructure design segment, the revenue increased 15.8% YoY to RMB7.7b with operating profit up 28.0% YoY to RMB1.1b. Gross margin widened 0.1 pcp YoY to 27.2% with operating margin up 1.3 pcp YoY to 14.0%. The backlog of contract for this segment is RMB10.7b.
- Port machinery segment revenue was up 10.7% YoY to RMB26.3b while operating profit increased 0.7% YoY to RMB3.5b. The gross margin narrowed 1.3 pcp YoY to 12.8% with operating margin down 1.3 pcp YoY to 13.4%. The margin squeeze was mainly due to RMB appreciation and failure of ZPMC to lock in raw material price in 1H and increased R&D expenses by ZPMC.
- Management guided that 2009 new contracts would be significantly higher than 2008 as the previous year was

hampered by snow storms, earthquake and Olympics.

Our view. CRG and CRC's strong IQ results and new contract wins are encouraging as we are expected growth in the infrastructure construction segment to further accelerate going into 2H 2009 as much of the railway construction projects moves into the ramp up stage. Currently, CCC is trading at 15.6x; CRG is trading at 18.0x; and CRC trading at 19.4x FY12/09F P/E on consensus. That said, we think the sector is fairly valued at present. Potential upside would come from: 1) announcements of a second stimulus package by the government; 2) any news relating to strong loan growth in the construction industry. Downside risk would come from: 1) project execution delays; 2) delays in funding or approval of new railway projects. We are neutral on CRC and CRG but most negative on CCC. CCC's exposure in railway remains too small to significantly drive overall top and bottom line growth while potential deceleration of traditional core segments, in particular the port machinery and dredging business may partially offset growth in railway. In terms of gross margin, we think that the company will face downside pressure in FY12/09F, due to: 1) the lower margin railway segment accounting for larger proportion of overall revenues; 2) increased priced competition in the highways segment; and 3) potential lesser contribution (in terms of overall turnover) from higher margin segments.

CSCI (3311 HK) a potential surprise in the making. China State Construction (3311 HK, HK\$1.89) may be a potential surprise in the sector. CSCI, which is 62.9% owned by China Overseas Holdings Ltd., is a leading construction and infrastructure investment company, with the largest market share in Hong Kong and exposure in emerging regions/countries such as Middle East, India and Macau. To date, the company has only limited exposure to infrastructure construction in China. However, we expect this to change. The company recently announced that they have entered into a sub-construction engagement agreement with parent CSCECL to participate in infrastructure construction in China. Subsequently, it has also formed a JV with CSCECL to tender for infrastructure projects in China. We expect China to be a new growth catalyst for the company. The counter is currently trading at 7.9x FY12/09F P/E on consensus.

Table 1: Financials

Company	FY12/08		FY12/08		1QFY12/09		1QFY12/09		YoY (%)
	Turnover (RMBb)	YoY (%)	Net Profit (RMBb)	YoY (%)	Turnover (RMBb)	YoY (%)	Net Profit (RMBb)		
390 HK	225.1	26.8	4.4*	66.7*	60.1	70.9	1.0	86.6	
1186 HK	219.4	27.6	4.2*	78.9*	51.3	56.1	0.9	33.9	
1800 HK	178.9	18.8	6.1	0.7	n.a.	n.a.	n.a.	n.a.	

*excluding forex loss effect

Source: Company Data

Table 2: Margins

Company	FY12/08		FY12/08		1QFY12/09		1QFY12/09		PcP
	Gross Profit (%)	PcP	Net Profit (%)	PcP	Gross Profit (%)	PcP	Net Profit (%)		
390 HK	7.3	0.1	2.0*	0.5*	7.5	(1.4)	1.6	0.1	
1186 HK	7.2	0.6	1.9*	0.5*	6.8	(0.1)	1.8	(0.3)	
1800 HK	10.0	(0.3)	3.4	(0.6)	n.a.	n.a.	n.a.	n.a.	

*excluding forex loss effect

Source: Company Data

Table 3: revenue breakdown

FY12/08A	390 HK		1186 HK		1800 HK	
	(RMBb)	(%)	(RMBb)	(%)	(RMBb)	(%)
Infrastructure construction	203.3	90.1	201.0	91.6	122.1	68.3
Dredging	n.a.	n.a.	n.a.	n.a.	19.0	10.6
Design	4.4	1.9	4.6	2.1	7.7	4.3
Manufacturing	6.9	3.1	4.8	2.2	26.3	14.7
Property development	3.8	1.7	n.a.	n.a.	n.a.	n.a.
Others	10.7	4.8	12.1	5.5	8.3	4.6
Elimination	(4.1)	(1.8)	(3.0)	(1.4)	(4.4)	(2.5)
Total	225.0	100.0	219.4	100.0	178.9	100.0

Source: Company Data

Table 4: Segment margin

FY12/08A	390 HK		1186 HK		1800 HK	
	GP(%)	OP (%)	GP(%)	OP(%)	GP(%)	OP(%)
Infrastructure construction	5.9	2.2	6.4	1.9	7.3	4.0
Dredging	n.a	n.a	n.a	n.a	14.3	11.7
Design	28.3	11.3	21.9	7.8	27.2	14.0
Manufacturing	16.9	11.2	12.9	5.5	12.8	13.4
Property development	30.1	14.9	n.a	n.a	n.a	n.a
Others	13.2	4.5	10.5	0.5	9.9	3.8

Source: Company Data

Table 5: FY12/08 Contract value

FY12/08A	390 HK				1186 HK				1800 HK			
	New Contract		Backlog		New Contract		Backlog		New Contract		Backlog	
	(RMBb)	(%)	(RMBb)	(%)	(RMBb)	(%)	(RMBb)	(%)	(RMBb)	(%)	(RMBb)	(%)
Infrastructure construction	383.5	96.9	399.2	97.0	399.0	94.3	459.1	97.5	212.0	76.5	265.6	80.3
Design	3.8	1.0	6.8	1.7	4.6	1.1	2.4	0.5	9.8	3.5	10.7	3.2
Manufacturing	8.5	2.1	5.5	1.3	3.5	0.8	4.0	0.9	31.0	11.2	35.6	10.8
Dredging									24.4	8.8	18.9	5.7
Others	n.a	n.a	n.a	n.a	15.9	3.8	5.5	1.2	n.a	n.a	n.a	n.a
Total	395.8	100.0	411.6	100.0	423.1	100.0	471.1	100.0	277.2	100.0	330.8	100.0

Source: Company Data & Bloomberg

Table 6: Valuation table

Company name	Ticker	Mkt cap (US\$m)	Last Price (Local)	Cur Est P/E (x)	Nxt Est P/E (x)	EV/EBITDA (x)	Cur Est ROE (%)	Est Yld (%)
HK-listed								
China Railway	390 HK	17,711.7	HK\$5.35	18.0	13.5	10.1	9.5	1.3
China Railway Cons	1186 HK	17,721.0	HK\$10.8	19.4	15.0	7.0	12.2	1.3
China Com Cons	1800 HK	18,937.0	HK\$9.34	15.5	12.6	9.5	16.9	1.4
China State Cons	3311 HK	640.7	HK\$1.89	7.9	6.7	5.4	20.5	4.1
Average				15.2	11.9	8.0	14.8	2.1
China-listed								
China Railway	601390 CH	17,711.7	RMB5.68	21.4	15.4	9.7	9.2	1.1
China Railway Cons	601186 CH	17,721.0	RMB9.56	19.9	15.1	7.2	10.9	1.3
Average				20.7	15.3	8.4	10.0	1.2

Source: Bloomberg

Table 7: 52 week high/low

(%)	390 HK	1186 HK	1800 HK	3311 HK
52 week high	HK\$7.74	HK\$14.00	HK\$19.42	HK\$3.25
52 week low	HK\$3.00	HK\$7.10	HK\$3.46	HK\$0.60

Source: Bloomberg, SBI E2-Capital

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