The 10-second briefing

Beijing Enterprises Water Group
371 HK

Target (HKD): **6.30 → 6.30**
Upside: **30.6%**
27 Feb price (HKD): **4.82**

Upgrading: correction overdone

- The solar-farm investment should be value-accretive for BEW's shareholders as its 32% ROE is higher than BEW's 14% in 2015E
- Recent share-price correction has created a buying opportunity
- Upgrading to Buy (1) with 12-month target price of HKD6.30, on attractive 0.7x 2013-16E PEG

1 **Buy** (from Outperform)
2 Outperform
3 Hold
4 Underperform
5 Sell

How do we justify our view?

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■ What's new

We see BEW's 8% share-price correction in February on concerns about its solar farm investment in Jin Cai Holdings (Not rated), as well as a series of reports on peer Sound Global (Not rated) by a short-sell organisation, as overdone. Hence, we upgrade our rating to Buy (1) on valuation grounds.

■ What's the impact

Solar investment to add value. We expect BEW's proposed investment in solar farms to create synergies with its water business, as we estimate the 200MW distribution-generation (DG) solar installation could cut the operating costs of its 12mtpd water plants by 7% pa. We see the solar investment as being value-accretive for BEW's shareholders and calculate the ROE on its HKD1.4bn investment for a 34.95% stake in Jin Cai to be 32%, higher than BEW's 14% ROE for 2015E (or 13% cash-based ROE). Our earnings forecasts only take into account the electricity cost savings from the DG projects.

Dominant WWT player. BEW recently raised its water capacity target and aims to double its operating-water market share from 2014-18E. Thus, we raise our 2014-16 annual capacity addition forecasts for BEW's water capacity to 4.5mtpd (previously: 3-3.5mtpd), and upgrade our 2016E EPS by 7%, also on the cost savings from the DG installation.

■ What we recommend

We now rate BEW as a Buy (1), backed by our unchanged DCF-based target price at HKD6.30, based on a 12-month horizon (6 months previously). BEW is trading at a 20x 2015E PER (0.3SD below its past-1-year average of 21.2x), which we see as attractive given our 31% 2013-16E EPS CAGR. The main risk: equity dilution, as we forecast BEW's net debt-to-equity ratio to rise to 166%/190% by end-2015/16, higher than its threshold level of 150%, after the Jin Cai investment and 1mtpd in new water capacity additions over 2014-16.

■ How we differ

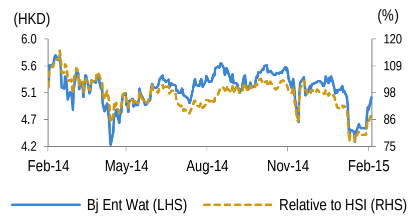
Our 2015E EPS is 3% below consensus, as we factor in higher finance costs for the Jin Cai investment and an extra 1mtpd new water capacity investment.

Forecast revisions (%)

Year to 31 Dec	14E	15E	16E
Revenue change	4.8	6.1	9.6
Net profit change	0.7	1.3	7.0
Core EPS (FD) change	(1.5)	1.3	7.0

Source: Daiwa forecasts

Share price performance



12-month range	4.23-5.73
Market cap (USDbn)	5.38
3m avg daily turnover (USDm)	16.43
Shares outstanding (m)	8,656
Major shareholder	Beijing Enterprises Holdings (43.9%)

Financial summary (HKD)

Year to 31 Dec	14E	15E	16E
Revenue (m)	9,146	11,715	13,773
Operating profit (m)	2,545	3,750	4,859
Net profit (m)	1,642	2,087	2,704
Core EPS (fully-diluted)	0.190	0.241	0.312
EPS change (%)	36.2	26.6	29.6
Daiwa vs Cons. EPS (%)	0.7	(3.2)	1.8
PER (x)	25.3	20.0	15.4
Dividend yield (%)	1.6	2.0	2.6
DPS	0.076	0.096	0.125
PBR (x)	2.9	2.7	2.4
EV/EBITDA (x)	21.3	16.0	13.5
ROE (%)	11.9	14.0	16.5

Source: FactSet, Daiwa forecasts

1 Buy (from Outperform)
2 Outperform
3 Hold
4 Underperform
5 Sell

How do we justify our view?

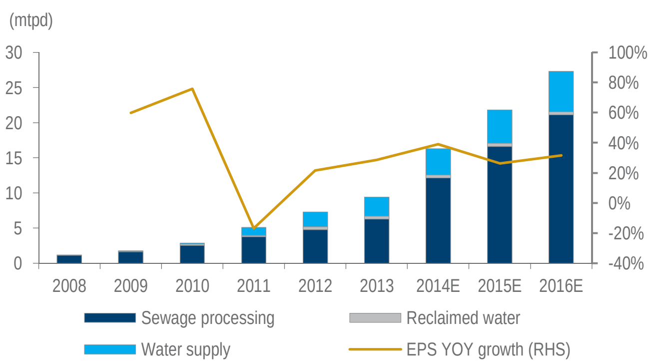
- Growth outlook ✔ ✔ ✔ ✔ ✔
- Valuation ✔ ✔ ✔ ✔ ✔
- Earnings revisions ✔ ✔ ✔ ✔ ✔

Growth outlook ✔ ✔ ✔ ✔ ✔

BEW expanded its total water treatment capacity from 1.53mtpd in 2008 to 18.16mtpd in 1H14, representing a 57% capacity CAGR over the period. In 1H14, BEW had 333 water projects, comprising 271 WWT projects, 13 reclaimed water projects, 48 water-supply projects and 1 seawater desalination project.

We now forecast capacity additions of 4.5mtpd (previously 3-3.5mtpd) a year for BEW's combined WWT and water-supply capacity over 2014-16, after the company presented a bullish target to double its operating-water project market share from 4.3% to almost 8.5% by 2018E. With such aggressive capacity expansion, we now forecast a 36% net profit CAGR for 2013-16 (previous: 33%).

BEW: total operating water capacity and EPS growth



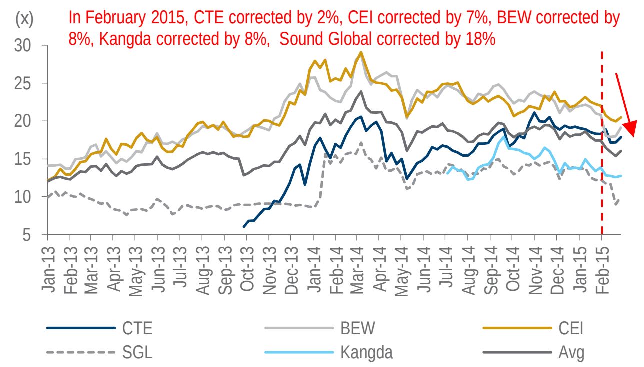
Source: Company, Daiwa forecasts

Valuation ✔ ✔ ✔ ✔ ✔

Since 2013, BEW has traded at a 1-year forward PER at the upper end of the 13-21x trading range of the China Water Sector (excluding Sound Global, which has featured recently in a short-selling organisation's reports). Backed by its high business growth profile, leading position in the municipal water-services industry and longer listing history vs. peers, BEW's correction, from a 21x forward PER at the start of February to 20x as of 27 February, is unjustified, in our view. The stock's 20x 2015E PER is 0.3SD below its past-1-year average of 21.2x.

We expect BEW's non-cash gross profit contribution from BT and BOT construction to fall from 28% in 2013 to 22% in 2015E, as more projects enter the operation phase.

China Water Sector: 1-year forward PER

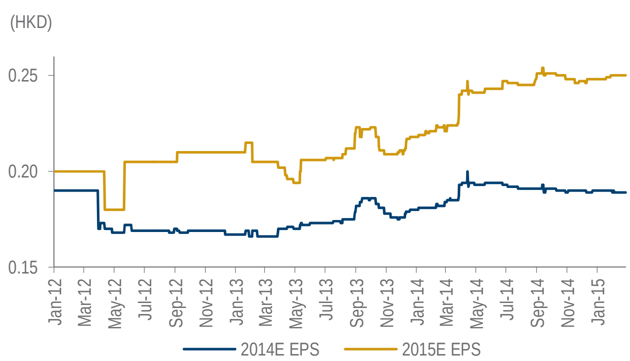


Source: Company, Bloomberg

Earnings revisions ✔ ✔ ✔ ✔ ✔

Since January 2014, the Bloomberg consensus has revised up its 2014 and 2015 EPS forecasts for BEW by 5% and 14%, respectively, on: 1) the company's solid 2013 EPS, which beat the consensus forecast by 14%, 2) new water projects acquisition momentum, with 2013 and 2014 new capacity additions of 6.2mtpd and 4.5mtpd both exceeding the 2mtpd annual target, and 3) BEW's decision to revise up its construction revenue gross-margin assumption for new BOT projects (from 11% to 23.9%) starting in 1H14. Our 2014-16E EPS are broadly in line with those of the consensus. We expect the recent solar investment and its higher new water capacity target to lead to continued EPS growth for 2017-18E.

BEW: consensus EPS forecasts



Source: Bloomberg

Financial summary

Key assumptions

Year to 31 Dec	2009	2010	2011	2012	2013	2014E	2015E	2016E
Year-end operating WWT and water reclaim capacity (mtpd)	1.62	2.71	3.96	5.16	6.68	12.56	17.06	21.56
WWT plant utilization rate (%)	71.4	79.6	76.8	79.8	75.0	80.0	81.0	82.0
WWT services tariff (HKD/ton)	1.07	1.07	1.15	1.16	1.22	1.23	1.24	1.26
Year-end operating water supply capacity (mtpd)	0.15	0.15	1.13	2.13	2.75	3.75	4.75	5.75
Water supply plant utilization rate (%)	63.2	86.9	38.6	42.8	41.5	44.0	46.5	49.0

Profit and loss (HKDm)

Year to 31 Dec	2009	2010	2011	2012	2013	2014E	2015E	2016E
Sewage and reclaimed water treatment services	440	592	995	1,425	2,141	3,230	5,076	6,620
Construction services	1,066	5,432	1,365	1,974	3,764	5,064	5,394	5,427
Other Revenue	225	325	295	328	501	851	1,245	1,726
Total Revenue	1,730	6,348	2,654	3,727	6,406	9,146	11,715	13,773
Other income	18	61	144	194	200	280	391	548
COGS	(1,214)	(5,226)	(1,746)	(2,290)	(3,901)	(5,507)	(6,597)	(7,393)
SG&A	(127)	(219)	(301)	(440)	(775)	(1,106)	(1,416)	(1,665)
Other op.expenses	(15)	(57)	16	(127)	(188)	(268)	(343)	(403)
Operating profit	392	906	768	1,064	1,743	2,545	3,750	4,859
Net-interest inc./(exp.)	(119)	(212)	73	(27)	(354)	(593)	(1,215)	(1,494)
Assoc/forex/extraord./others	5	1	21	55	108	190	205	209
Pre-tax profit	277	695	861	1,092	1,497	2,142	2,740	3,575
Tax	(49)	(131)	(170)	(225)	(352)	(407)	(536)	(718)
Min. int./pref. div./others	(36)	(52)	(90)	(117)	(61)	(93)	(118)	(152)
Net profit (reported)	193	513	601	750	1,084	1,642	2,087	2,704
Net profit (adjusted)	193	513	601	750	1,084	1,642	2,087	2,704
EPS (reported)(HKD)	0.061	0.107	0.089	0.109	0.140	0.190	0.241	0.312
EPS (adjusted)(HKD)	0.061	0.107	0.089	0.109	0.140	0.190	0.241	0.312
EPS (adjusted fully-diluted)(HKD)	0.061	0.107	0.089	0.109	0.140	0.190	0.241	0.312
DPS (HKD)	0.000	0.000	0.031	0.042	0.055	0.076	0.096	0.125
EBIT	392	906	768	1,064	1,743	2,545	3,750	4,859
EBITDA	426	945	815	1,134	1,865	2,797	4,188	5,473

Cash flow (HKDm)

Year to 31 Dec	2009	2010	2011	2012	2013	2014E	2015E	2016E
Profit before tax	277	695	861	1,092	1,497	2,142	2,740	3,575
Depreciation and amortisation	34	39	47	70	122	252	438	614
Tax paid	(49)	(131)	(170)	(225)	(352)	(407)	(536)	(718)
Change in working capital	(143)	(2,982)	(100)	1,121	808	(469)	(1,036)	(1,138)
Other operational CF items	(1,252)	(859)	(2,836)	(2,486)	(3,011)	(1,723)	(1,497)	(938)
Cash flow from operations	(1,132)	(3,238)	(2,198)	(427)	(936)	(205)	110	1,394
Capex	(107)	(141)	(204)	(109)	(70)	(979)	(945)	(626)
Net (acquisitions)/disposals	(51)	(75)	(1,877)	(407)	(4,395)	(5,546)	(5,772)	(6,613)
Other investing CF items	23	(616)	584	(44)	1,607	0	0	0
Cash flow from investing	(136)	(831)	(1,496)	(560)	(2,857)	(6,525)	(6,717)	(7,238)
Change in debt	1,156	4,624	95	3,450	380	4,865	7,137	6,580
Net share issues/(repurchases)	0	0	3,385	0	2,297	0	0	0
Dividends paid	(5)	(6)	(66)	(2)	0	0	0	0
Other financing CF items	159	483	162	(479)	(763)	0	0	0
Cash flow from financing	1,309	5,101	3,576	2,969	1,914	4,865	7,137	6,580
Forex effect/others	0	0	0	0	0	0	0	0
Change in cash	42	1,032	(118)	1,981	(1,879)	(1,866)	529	737
Free cash flow	(1,239)	(3,379)	(2,402)	(536)	(1,005)	(1,184)	(835)	769

Source: FactSet, Daiwa forecasts

Financial summary continued ...

Balance sheet (HKDm)

As at 31 Dec	2009	2010	2011	2012	2013	2014E	2015E	2016E
Cash & short-term investment	891	2,554	2,016	3,725	5,423	3,028	2,820	2,611
Inventory	7	13	13	30	55	52	67	77
Accounts receivable	287	4,885	4,018	2,800	3,172	3,518	4,718	5,590
Other current assets	711	1,368	5,608	7,124	6,562	7,744	9,965	11,900
Total current assets	1,896	8,820	11,654	13,679	15,212	14,341	17,570	20,178
Fixed assets	259	46	233	528	379	414	446	479
Goodwill & intangibles	1,579	1,585	1,650	1,779	2,539	2,537	2,535	2,533
Other non-current assets	3,690	6,773	11,212	15,304	26,057	33,388	40,742	47,945
Total assets	7,424	17,225	24,750	31,290	44,187	50,679	61,292	71,135
Short-term debt	1,291	5,296	1,070	2,810	2,148	2,148	2,148	2,148
Accounts payable	445	2,638	2,049	1,919	2,755	2,964	3,814	4,408
Other current liabilities	515	683	3,552	4,529	6,748	7,595	9,146	10,231
Total current liabilities	2,251	8,617	6,671	9,258	11,651	12,706	15,107	16,786
Long-term debt	1,903	3,231	7,691	10,465	15,303	19,345	26,482	33,062
Other non-current liabilities	258	309	678	836	1,308	1,604	1,310	1,118
Total liabilities	4,412	12,157	15,039	20,558	28,262	33,655	42,898	50,966
Share capital	348	457	691	691	844	866	866	866
Reserves/R.E./others	2,275	3,436	7,391	7,776	12,454	13,439	14,691	16,314
Shareholders' equity	2,623	3,893	8,082	8,467	13,298	14,305	15,557	17,179
Minority interests	389	1,175	1,629	2,264	2,627	2,719	2,837	2,990
Total equity & liabilities	7,424	17,225	24,750	31,290	44,187	50,679	61,292	71,135
EV	44,412	48,750	48,083	51,116	53,350	59,689	66,947	73,679
Net debt/(cash)	2,303	5,973	6,745	9,550	12,028	18,465	25,809	32,598
BVPS (HKD)	0.753	0.852	1.170	1.225	1.576	1.653	1.797	1.985

Key ratios (%)

Year to 31 Dec	2009	2010	2011	2012	2013	2014E	2015E	2016E
Sales (YoY)	412.3	266.9	(58.2)	40.4	71.9	42.8	28.1	17.6
EBITDA (YoY)	264.8	121.8	(13.8)	39.1	64.5	49.9	49.7	30.7
Operating profit (YoY)	257.4	131.1	(15.3)	38.6	63.8	46.0	47.4	29.6
Net profit (YoY)	522.0	165.9	17.2	24.9	44.5	51.5	27.1	29.6
Core EPS (fully-diluted) (YoY)	59.9	75.9	(16.8)	21.5	28.7	36.2	26.6	29.6
Gross-profit margin	29.8	17.7	34.2	38.6	39.1	39.8	43.7	46.3
EBITDA margin	24.6	14.9	30.7	30.4	29.1	30.6	35.8	39.7
Operating-profit margin	22.7	14.3	28.9	28.5	27.2	27.8	32.0	35.3
Net profit margin	11.1	8.1	22.6	20.1	16.9	18.0	17.8	19.6
ROAE	8.8	15.7	10.0	9.1	10.0	11.9	14.0	16.5
ROAA	3.1	4.2	2.9	2.7	2.9	3.5	3.7	4.1
ROCE	12.6	9.2	4.8	5.0	6.1	7.1	8.8	9.5
ROIC	12.2	9.0	4.5	4.6	5.5	6.5	7.6	8.0
Net debt to equity	87.8	153.4	83.5	112.8	90.4	129.1	165.9	189.8
Effective tax rate	17.5	18.8	19.7	20.6	23.5	19.0	19.5	20.1
Accounts receivable (days)	66.6	148.7	612.1	333.8	170.1	133.5	128.3	136.6
Current ratio (x)	0.8	1.0	1.7	1.5	1.3	1.1	1.2	1.2
Net interest cover (x)	3.3	4.3	n.a.	39.8	4.9	4.3	3.1	3.3
Net dividend payout	0.0	0.0	34.5	38.9	39.3	40.0	40.0	40.0
Free cash flow yield	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	1.8

Source: FactSet, Daiwa forecasts

Company profile

As the environmental water utilities flagship company under parent group Beijing Enterprises Holdings, Beijing Enterprises Water Group provides a full range of water services comprising water supply, sewage treatment, reclaimed water and seawater desalination. The company had treatment capacity of 11.53mtpd in operation and 6.45mtpd under construction at end-June, 2014. It is one of the top-3 water supply and sewage treatment companies in China in terms of total capacity.

Correction overdone

Correction caused by concerns about BEW's solar investment has created a buying opportunity

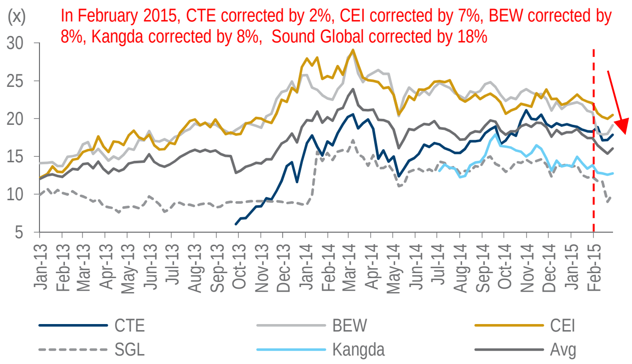
What has led to the share-price correction?

Over the month of February 2015, the China Water Sector corrected by 6-27%, due mainly to:

1) The publication of a number of short-selling reports by an agency on Sound Global questioning its engineering, procurement and construction (EPC) margin and rising receivables.

2) Market concerns that BEW's solar farm investment through Hong Kong-listed Jin Cai will destroy shareholder value.

■ China Water Sector: 1-year forward PER bands



Source: Company, Bloomberg, Daiwa forecasts

Note: Sound Global is not covered by Daiwa and hence data for the company is sourced from Bloomberg; CTE = CT Environmental (1363 HK, HKD7.8, Buy); CEI = China Everbright International (257 HK, HKD10.82, Outperform); Kangda= Kangda International Environmental (6136 HK, HKD3.21, Outperform)

Solar and BT are likely the concerns

The short-selling reports on Sound Global have raised concerns in the market that the company's EPC or BT projects have given rise to cash-flow concerns, as companies usually take more than 6 months to collect payments from local governments.

In this report, we debate whether, as a result of these short-selling reports, BEW has been unduly punished by the market for its solar farm investment and BT exposure.

Will the solar investment destroy value of BEW?

On 3 February, 2015, BEW and its management proposed to acquire a total 47% (including management's stake) holding in Jin Cai over 2015-16 to invest in the solar farm business. BEW plans to invest HKD417m initially to take a 30.42% stake in Jin Cai, which could reach 34.95% with an additional HKD983m via preference shares over 2015-16. BEW's CEO, Mr Hu Xiaoyong, VP Mr Li Hai Feng, and Executive Director, Mr Zhou Min would have a collective 12.12% stake in Jin Cai.

Details of the Jin Cai investment

The gross proceeds (including those from other subscribers) would amount to HKD1.1bn and reach HKD3.7bn after the conversion of preferred shares. BEW's share of the investment would be HKD417m, which could rise to HKD1.4bn after the conversion of the preferred shares.

■ **BEW: Jin Cai shareholding structure after the corporate restructuring**

Subscribers	Position	Before the deal		Before conversion of Preference Shares			After conversion of Preference Shares		
		O/S shares (mn)	% of total shares	Ordinary shares (mn)	Consideration (HKD mn)	% of enlarged share	With preferred shares (mn)	Consideration (HKD mn)	% of enlarged share
BEW				527	417	30.42	1,772	1,400	34.95
Hu Xiaoyong	ED, CEO of BEW			78	62	4.52	263	208	5.19
Li Haifeng	ED, VP of BEW			57	45	3.29	192	151	3.78
Zhou Min	ED of BEW			48	38	2.74	160	126	3.15
Subtotal				710	561	40.97	2,387	1,885	47.07
CITIC PE Associates II				226	179	13.04	759	600	14.98
Beijing Youde Investment Management Centre				226	179	13.04	759	600	14.98
Other subscribers				251	199	14.62	844	667	16.66
Huang Li	Director of JCH	240	75	240		13.75	240		4.73
Existing Shareholders		80	25	80		4.58	80		1.58
Total		320	100	1,734	1,117	100	5,070	3,752	100

Source: HKEx, Daiwa research

With potential net proceeds of HKD3.7bn, Jin Cai has revealed a plan to invest in PV solar projects over 2015-17, with: 1) 25 grid-connected solar power plants with aggregate installed capacity of 450MW, 500MW and 550MW in 2015, 2016 and 2017, respectively, and 2) DG solar plants with an aggregate installed capacity of 50MW, 100MW and 50MW in 2015, 2016 and 2017, respectively, using vacant land at BEW's water plants. According to BEW's management, the 200MW DG capacity would cover 12mtpd of its WWT plant capacity as of 2014. Therefore, there could be upside to its DG capacity growth in the future.

■ **Jin Cai: solar farm investment targets for 2015-17**

	Unit	
Total target investment for 2015-17	CNY bn	13.84
Total target installed grid-connected solar capacity	MW	1,500
Total target installed distributed-generation solar capacity	MW	200
Total target installed solar capacity	MW	1,700
Per-watt solar investment	CNY/W	8.14

Source: Company, Daiwa research

Jin Cai estimates the total investment for the development of these power plants in each of 2015, 2016 and 2017 will amount to around CNY3.72bn, CNY4.867bn and CNY5.255bn, respectively, of which about 30% is expected to be funded using internal resources (HKD3.7bn net proceeds from investors including BEW and also internal cash) and 70% via bank borrowings. The following table shows the capital schedule for Jin Cai's solar investment.

■ **Jin Cai: capital plan for 2015-17**

	Unit	
Total target investment for 2015-17	CNY bn	13.84
Total target equity investment for 2015-17, assuming 30% equity	CNY bn	4.15
Capital injection through share subscriptions from BEW and other parties	HKD bn	3.75
Capital injection through share subscriptions from BEW and other parties	CNY bn	2.98
Internal cash resources from JCH	CNY bn	1.17

Source: Company, Daiwa research

Electricity cost savings for BEW's 12mtpd water plants from the 200MW DG projects

During a conference call held by BEW on 3 February 2015, management said it expects the acquisition to create synergies with its water business. The distributed solar power plants would utilise the vacant land at BEW's water plants. BEW would enjoy a 10% tariff discount in return, or around 10% of CNY0.7/kWh, and in addition it would enjoy the 34.95% stake in the CNY0.63/kWh on-grid tariff and the CNY0.42/kWh subsidy tariff enjoyed by JCH.

Therefore, BEW could enjoy a CNY0.44/kWh ((CNY0.07+(CNY0.63+0.42)*34.95%)) tariff benefit by introducing DG projects, of which 30% of its total electricity bill (at 1.35bn kWh) would be contributed by a 200MW DG located inside a 12mtpd WWT plant area.

The total revenue generated by the 200MW DG projects on the 12mtpd WWT plants could be CNY177m (CNY0.44/kWh x 1.35bnkWh x 30%), representing about 20% of the electricity bill for the 12mtpd WWT plant amounting to CNY945m. Given electricity costs represent 40% of BEW's operating cost for its water plants, we estimate the DG installation could reduce the total cost of its 12mtpd water plant operation by 7% pa.

■ **BEW: cost savings through Jin Cai's DG projects**

	Unit	
Total electricity to be replaced by solar DG	m kWh	203
Utilization hour	hours	1,000
Total solar DG capacity	MW	203
Total % of electricity bill to be replaced by DG		30%
Portion of electricity bill to be replaced by DG	m kWh	405
Average tariff	CNY/kWh	0.70
Percent discount enjoyed by BEW		10%
Average tariff discount enjoyed by BEW	CNY/kWh	0.07
Average tariff collected from BEW by Jin Cai (1250 HK)	CNY/kWh	0.63
Subsidiary tariff on DG project	CNY/kWh	0.42
Total tariff collected by Jin Cai (1250 HK)	CNY/kWh	1.05
Effective stake in Jin Cai (1250 HK) by BEW		34.95 %
Total associated tariff on BEW	CNY/kWh	0.37
Total tariff benefit by BEW	CNY/kWh	0.44
Total earnings enjoyed by BEW by installing DG projects of existing WWT plant	CNY m	177
Electricity bill for the 12mtpd WWT plants	CNY m	945
% of electricity cost saving through DG projects		19%
Electricity cost as total COGS		40%
% of total COGS saved		7.5%

Source: Company, Daiwa research

In our model, we have included the cost savings and the HKD1.8bn consideration to acquire the 34.95% stake, without taking the share of the 1.5GW grid-connected solar power, which we estimate will contribute an additional HKD550m 2018E EBIT for BEW, representing 7% upside potential for BEW's 2018E EBIT.

■ **BEW: EBIT enhancement from Jin Cai's gird-connected solar projects**

	Unit	
EBIT for a 30MW solar farm in Xinjiang	CNY m	25
EBIT for a 1.5GW solar farm in Xinjiang	CNY m	1,250
BEW's 34.95% share of JCH's EBIT	CNY m	437
BEW's 34.95% share of JCH's EBIT	HKD m	550
BEW's 2018E EBIT	HKD m	7,429
% of additional EBIT contribution		7.0%

Source: Company, Daiwa estimates

Solar investment will add value on our calculations, and enhance ROE

In order to prove that the solar investment would not destroy value for BEW shareholders, we need to see whether the investment can cover the opportunity cost (or at least the finance cost) of the HKD1.4bn BEW will invest in the 34.95% ordinary shares and preferred shares.

We estimate BEW's financing cost is HKD70m, assuming a 5% interest rate, which would be offset by the potential HKD517m net profit generated by the investment (or HKD223m net profit for the DG projects alone). Based on our calculations, the ROE on the HKD1.4bn investment for the 34.95% stake in Jin Cai could reach 32% (including electricity cost savings, a 34.9% share of Jin Cai's earnings from the 200MW DG projects, and a 34.9% share of Jin Cai's earnings from the 1.5GW grid-connected projects), higher than the 14% ROE we forecast for 2015E (or 13% cash-based ROE). Such a high ROE is mainly due to the BEW's low 5% financing cost (versus pure-solar IPPs at 7-8%) and also the preferential tax policy for the initial six-year operation. A typical grid-connected solar farm project, with a financing cost of 7%, should have an ROE of 25-30% in its first 3 years of operation (with tax exemption), falling to 18-20% after the preferential tax period ends.

Given the higher ROE we forecast for Jin Cai's investment vs. the 2015E ROE for BEW as a whole, we expect the Jin Cai investment to be value-accretive for BEW's shareholders.

In our model, we have a more conservative estimate in that we only account for the savings on BEW's electricity bills, excluding the 34.95% share of Jin Cai's earnings from the 200MW DG/1.5GW grid-connected solar projects. Our calculations only account for the national tariff subsidy for the DG projects, so there could be further upside if the local authorities provide additional subsidies.

■ **BEW: financial impact from investment in Jin Cai**

	Unit
Total earnings accrued to BEW from installing 200MW DG projects into its existing WWT plants (12mtpd)	CNY177m
Total earnings accrued to BEW from installing 200MW DG projects into its existing WWT plants (12mtpd)	HKD223m
BEW's 34.95% share of Jin Cai's EBIT from grid-connected 1.5GW solar farms	HKD550m
BEW's 34.95% share of Jin Cai's debt repayment	HKD256m
BEW's 34.95% share of Jin Cai's PBT/ or net profit (tax-free during the initial 3 years' of operation)	HKD294m
Total BEW's 34.95% share of Jin Cai's net profit	HKD517m
Total BEW's equity investment for the 34.95% stake in Jin Cai	HKD1,400m
Finance cost	5%
BEW's financing cost for the 34.95% Jin Cai stake investment	HKD70m
BEW's net profit enhancement from the Jin Cai investment	HKD447m
Jin Cai's ROE for BEW	32%
BEW's 2015E ROE	14.2%

Source: Company, Daiwa estimates

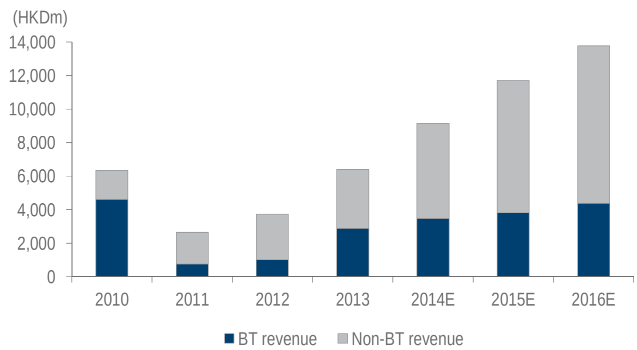
Note: Solar projects in China enjoy a preferential tax rate with a full exemption for 3 years and half-tax exemption for 3 years

BT construction earnings would gradually drop

After the recent series of short-selling reports published by an agency on Sound Global, we believe investors would now prefer water companies with more exposure to operating earnings, rather than to EPC/BT construction earnings, given that for EPC/BT earnings, payment from the government can take at least 6 months to receive.

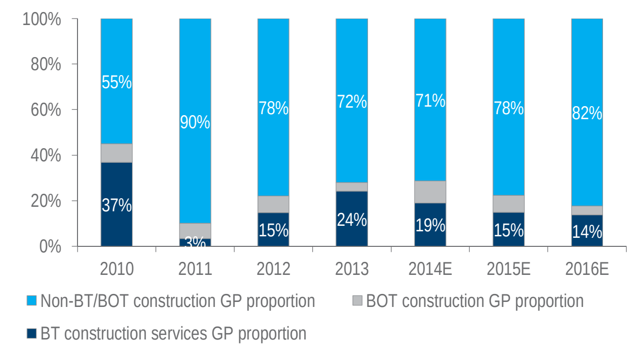
Unlike the emerging water companies' focus on BOT projects, or EPC projects, BEW, as the No.2 China water utilities company in terms of total water capacity, sees a higher contribution from operating gross profit, which rose from 72% in 2013 to 82% in 2016E, and hence less exposure to BT contribution, which dropped from 24% in 2013 to 14% in 2016E, given the company is not planning to aggressively expand its BT construction services business, given the time required to collect payment from the government.

■ BEW: BT and non-BT revenue forecasts



Source: Company, Daiwa estimates

■ BEW: BT, BOT construction and non-construction gross-profit proportion



Source: Company, Daiwa estimates

As a result, the market's concerns about BEW being exposed to prolonged receivables on BT/EPC projects should recede in the future.

Valuation

We are upgrading our rating on BEW to Buy (1), from Outperform (2), with an unchanged DCF-derived target price of HKD6.30, now based on a 12-month horizon (previously 6 months), supported by our 36% net profit CAGR forecast (previous: 33%) for 2013-16, or 31% EPS CAGR (previous: 28%) during the same period.

Considering the predictable long-term cash flow associated with BEW's municipal water supply business, WWT BOT and TOT project capacity additions, and tariff forecasts in 2014-16, we value BEW using DCF methodology. We are increasing our WACC assumption from 6.1% to 6.2%, given we believe investors will be more risk-averse on the water sector going forward as a result of the short-selling reports on Sound Global.

Our DCF-based valuation yields a fair value of HKD6.30/share, equivalent to a 2015E PER of 26x.

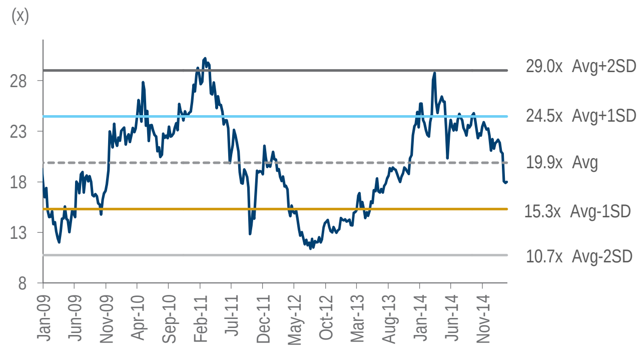
Since 2013, BEW has traded at a 1-year forward PER at the upper end of the China Water Sector's (excluding Sound Global) trading PER range of 13-21x. Backed by its high business growth profile, leading position in the municipal water-services industry and longer listing history vs. peers, BEW's recent correction, from a 21x forward PER at the beginning of February to 20x as of 27 February, is unjustified, in our view.

BEW's current 20x 2015E PER is 0.3SD below its past-1-year average of 21.2x. Over the past 6 years, the stock has traded below this historical average as the market has become more risk-averse, which has led to panic selling of small-cap (USD3bn or lower market cap stocks), which we believe explains the share price volatility of BEW.

As we consider BEW to be in the process of transforming itself from a mid-cap (USD5bn market cap) stock to a large-cap (to USD10bn-plus market cap) by 2018E, we think its PER should remain stable at above 20x over our forecast horizon.

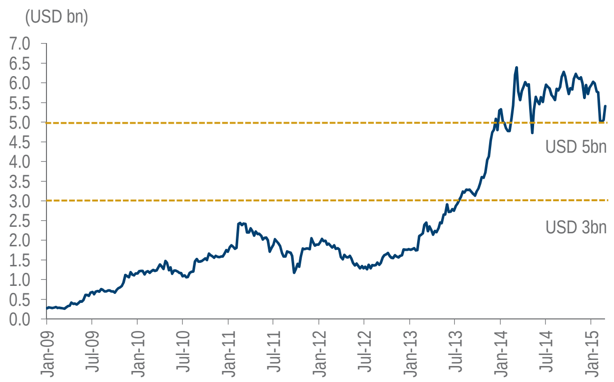
We argue that BEW deserves a premium valuation for its position as the only Hong Kong-listed China water operator with large WWT exposure, a decent project portfolio, a solid track record and sizeable market cap; and we think the company will continue to be appreciated by investors.

■ BEW: 1-year forward PER



Source: Bloomberg

■ BEW: market capitalisation



Source: Bloomberg

■ China: top-10 water utilities in terms of capacity at end-2014

		Ticker	Water Cap (mtpd)	Market share
1	Shanghai City Investment	600649 CH	28.19	4.9%
2	Beijing Enterprises Water	371 HK	24.88	4.3%
3	Beijing Capital	600008 CH	15.68	2.7%
4	Veolia China	VIE FP	13.52	2.4%
5	Guangdong Investment	270 HK	12.45	2.2%
6	Sino French Water	Not listed	11.66	2.0%
7	SIIC Environment	SIIC SP	9.67	1.7%
8	China Water Investment	Not listed	9.50	1.7%
9	Shenzhen Water Group	Not listed	7.26	1.3%
10	General Water of China	Not listed	7.01	1.2%
Top 10			139.82	24.4%

Source: H2O China, Daiwa research

■ BEW: DCF valuation

(HKDm)	2014E	2015E	2016E	2017E	2018E	2019E	2020E	2021E	2022E	2023E	2024E	2025E	2026E	2027E	2028E	2029E	2030E
EBIT (IFRIC 12)	3,046	3,979	5,126	6,261	7,425	7,995	8,514	9,082	9,711	10,348	10,996	11,736	12,439	13,182	13,966	14,792	15,660
BOT construction revenue	(1,606)	(1,589)	(1,052)	(1,567)	(1,555)	-	-	-	-	-	-	-	-	-	-	-	-
BOT construction cost	1,253	1,210	801	1,192	1,184	-	-	-	-	-	-	-	-	-	-	-	-
Reinstatement of operation income	(450)	(182)	55	126	240	273	230	182	129	70	6	(63)	5	73	142	210	279
EBIT (non-IFRIC 12)	2,243	3,417	4,930	6,013	7,293	8,268	8,744	9,264	9,840	10,418	11,003	11,673	12,444	13,255	14,108	15,002	15,940
Share of JVE/associates	190	205	209	214	219	224	229	184	188	192	197	201	205	209	214	218	223
Depreciation	252	438	614	794	922	1,037	946	863	787	718	655	598	545	498	454	414	378
Tax	(340)	(461)	(668)	(841)	(1,069)	(1,301)	(1,450)	(1,605)	(1,792)	(1,987)	(2,192)	(2,427)	(2,603)	(2,790)	(2,987)	(3,195)	(3,413)
Minority interest	(93)	(118)	(152)	(189)	(228)	(250)	(270)	(290)	(314)	(337)	(361)	(389)	(417)	(447)	(478)	(512)	(547)
Change in working capital	(469)	(1,036)	(1,138)	(1,106)	(1,176)	(953)	(354)	35	42	53	(233)	(243)	(230)	(216)	(224)	(232)	(240)
CAPEX and acquisition	(6,525)	(6,717)	(7,238)	(6,236)	(6,192)	(28)	(27)	(25)	(23)	(22)	(20)	(19)	(18)	(17)	(16)	(15)	(14)
Free cash flow (FCF) under IFRIC12	(4,741)	(4,272)	(3,444)	(1,352)	(231)	6,996	7,817	8,426	8,729	9,036	9,048	9,395	9,926	10,493	11,071	11,682	12,328

Sum PV Cash Flow (2015-24)	24,742
PV of Terminal Value (from 2025)	58,534
Minus net debt on Balance Sheet	(27,641)
Equity Value (HKD)	55,634
NPV/Share (HKD)	6.30

Valuation assumption	
China Risk Free Rate	4.0%
Market Risk Premium	10.0%
Beta	0.60
Cost of Equity	10.0%
Yr n-1 Debt/Capitalisation	60%
Pre-Tax Cost of Debt	5.0%
After Tax Cost of Debt	3.8%
WACC	6.2%

Source: Daiwa forecasts

■ BEW: our target price (HKD) sensitivity to WACC and terminal growth rate assumptions for DCF calculation

		WACC				
		5.2%	5.7%	6.2%	6.7%	7.2%
Terminal Growth Rate	2.0%	12.73	9.99	7.94	6.36	5.11
	1.5%	10.96	8.74	7.03	5.68	4.59
	1.0%	9.61	7.76	6.30	5.12	4.16
	0.5%	8.54	6.96	5.69	4.65	3.79
	0.0%	7.68	6.31	5.18	4.25	3.47

Source: Daiwa forecasts

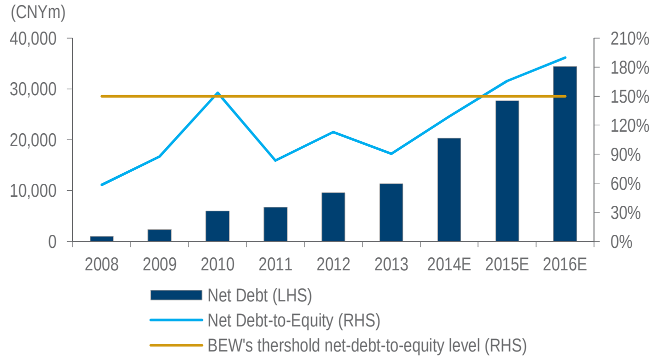
Key investment risks

Equity dilution

We expect BEW to be in a rapidly developing phase typified by high capex and negative FCF over the next few years. Although we think the company should be able to fund its future projects through debt financing at a competitive borrowing rate of c.5%, we do not rule out the possibility that it may have to seek equity financing, potentially by end-2015E, given it has upgraded its new water capacity target by 2018E, and in the meantime has committed HKD1.4bn to invest in the solar farm business via Jin Cai.

If the company chooses a form of equity financing, such as share placements and/or the issuance of convertible bonds, EPS growth would be diluted. We forecast BEW's net debt-to-equity ratio to rise to 166% in 2015, slightly higher than the company's 150% threshold level.

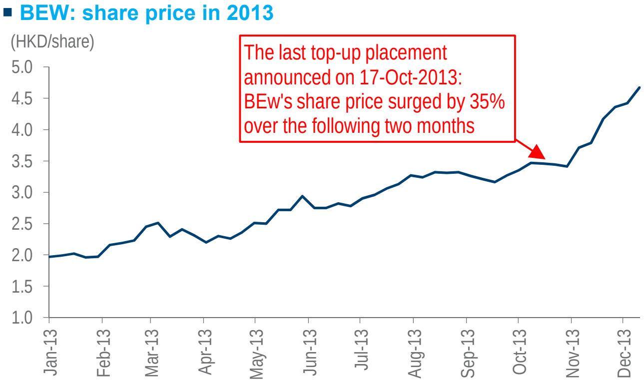
■ **BEW: net debt and net-debt-to-equity ratio**



Source: Company, Daiwa forecasts

However, we are not too concerned about potential equity financing, given BEW's share price rose by 35% from HKD3.4/share to HKD4.6/share within 2 months of the previous HKD1.1bn top-up equity placement on 17 October 2013, and as we believe investors were expecting BEW to further accelerate new projects wins with the net proceeds from the October 2013 placement.

■ **BEW: share price in 2013**



Source: Bloomberg

■ **BEW: share issuance since 2011**

Announcement date	Shares issued (m shares)	% of enlarged share capital at time of announcement	Issue price (HKD)	% discount to share price on last full trading day before announcement	Note	Share issue date
22-Dec-10	2,283	33.33%	1.485	46.00%	2-for-1 Open Offer	15-Mar-11
6-Jul-11	59	0.85%	2.134	8.40%	Consideration shares for the acquisition of Shenzhen Bei Kong Chuang Xin Investment	7-Sep-11
18-Jul-12	658	9.53%	1.62	20% premium	Consideration shares for the asset injection from BEHL	5-Feb-13
18-Jul-12	118	1.71%	1.62	20% premium	Consideration shares for the asset injection from BEHL regarding the transfer of BE Water (Hainan)	24-May-13
26-Sep-13	400	4.95%	2.95	5.10%	Subscriber was Mount Reskit Investment Ltd, a strategic investment fund owned by the Malaysia Government	16-Oct-13
17-Oct-13	350	4.15%	3.21	5.30%	Top-up placement	30-Oct-13
17-Jul-13	220	3.20%	2.82	7.55%	Consideration shares for the acquisition of Crystal Water and China Water Holdings, for which the companies entered into an MOU on 17 July 2013. The issue price was determined at a 5% discount to the volume-weighted average price for the 10 trading days prior to the announcement	19-Feb-14

Source: Company

Policy headwinds

The strong performance of the water sector players over the past few years has mainly been driven by policy tailwinds via the government regulating, promoting and investing in the water industry. For example the government has allocated investments of CNY410bn and CNY427bn for the water supply and municipal WWT industries, respectively, during the 12th FYP period. Other financial incentives or preferential policies for the WWT operators include, but are not limited to, guaranteed returns of 8-12% on water-supply projects, water tariff reforms and the central government's assessment of the local government's work.

Our investment case for BEW is built on the assumption that the China Water Sector will see continuous prosperity; and any negative changes in the supportive government policies could have a material impact on our view for the whole sector.

Market competition

Fiercer-than-expected market competition could lead to a slowdown in capacity expansion, and could even result in lower-than-expected project returns. Nevertheless, we believe BEW will continue to stand out as a leading China water company, given its SOE parental support, competitive borrowing costs and solid management team. We forecast BEW to expand its market share from 4.3% for 2014E to 8.5% by 2018E.

The credibility of the local governments

Many of BEW's projects are operated under concession rights agreements (BOT/BT/TOT), for which BEW collects construction and/or sewage treatment fees from the local government. If the local government's balance sheet deteriorates, it may postpone or default on payments. If the local government provided any misleading information when transferring the plant to BEW, the company could be affected by lower-than-expected project returns. BEW's seawater desalination project in Caofeidian is barely running, and the local government has failed to stick to its guaranteed utilisation for the plant, due partially to insufficient demand at the current tariff of CNY5.99/tonne (compared with the national average tap water tariff of CNY2.0/tonne).

Nevertheless, as BEW operates mainly in the higher-tier China cities and is backed by its SOE parent, we think the company is not highly exposed to this risk.

Appendix I – IRR analysis of 30MW grid-connected solar project

■ Grid-connected solar projects: assumptions of IRR analysis

Assumptions		
Capacity	(MW)	30
Operation	(Years)	20
Unit-capex (including VAT)	(CNY/W)	8.0
Unit-capex (excluding VAT)	(CNY/W)	7.1
Total investments (including VAT)	(CNYm)	240
Total investments (excluding VAT)	(CNYm)	212
Tariff (including VAT)	(CNY/kWh)	1.0
Tariff (excluding VAT)	(CNY/kWh)	0.9
Utilization hours	(hours)	1,600
Degradation (1st year)	(%)	2.0%
Degradation (2nd year and after)	(%)	0.8%
Self-use rate	(%)	5.0%
Debt	(%)	60%
Finance cost	(%)	7%
Initial operating expenses	(% revenue)	15%

Source: Daiwa research

■ Grid-connected solar project: project IRR analysis

	Apr-14	Apr-15	Apr-16	Apr-17	Apr-18	Apr-19	Apr-20	Apr-21	.....	Apr-31	Apr-32	Apr-33	Apr-34
Gross electricity generated (m kWh)		48	47	47	46	46	46	45	.....	42	41	41	41
Electricity self-consumed (m kWh)		(2)	(2)	(2)	(2)	(2)	(2)	(2)		(2)	(2)	(2)	(2)
Net electricity generated (m kWh)		46	45	44	44	44	43	43		40	39	39	39
Income statement (CNYm)													
Total revenue		42	41	41	40	40	40	39	.....	36	36	36	35
Depreciation		(11)	(11)	(11)	(11)	(11)	(11)	(11)		(11)	(11)	(11)	(11)
Operating expenses		(6)	(6)	(6)	(6)	(6)	(6)	(6)		(5)	(5)	(5)	(5)
EBIT		25	24	24	24	23	23	23		20	20	20	19
EBIT margin (%)		60%	59%	59%	59%	58%	58%	58%		56%	55%	55%	55%
Interest expense		(9)	(8)	(8)	(7)	(6)	(5)	(4)		0	0	0	0
Profit before tax		16	16	16	17	17	18	18		20	20	20	19
Income tax		0	0	0	(2)	(2)	(2)	(5)		(5)	(5)	(5)	(5)
Net profit		16	16	16	15	15	16	14	.....	15	15	15	15
Net margin (%)		38%	39%	40%	36%	38%	39%	35%		42%	42%	41%	41%
Non-cash items		11	11	11	11	11	11	11		11	11	11	11
Net repayment in debt		(9)	(10)	(11)	(11)	(12)	(13)	(14)		(0)	(0)	(0)	(0)
FCFE	(85)	17	17	16	14	14	13	11	.....	26	26	25	25
Equity IRR	18%												
Debt schedule													
Outstanding debt	127	118	108	98	86	74	61	48	.....	(0)	(0)	(0)	(0)
Repayment		(18)	(18)	(18)	(18)	(18)	(18)	(18)		0	0	0	0
Interest expense		(9)	(8)	(8)	(7)	(6)	(5)	(4)		0	0	0	0
VAT rebate schedule													
VAT rebate (%)		8.5%	8.5%	8.5%	8.5%	8.5%	8.5%	8.5%		8.5%	8.5%	8.5%	8.5%
Tax schedule													
Tax rate (%)		0%	0%	0%	13%	13%	13%	25%		25%	25%	25%	25%

Source: Daiwa research

Daiwa's Asia Pacific Research Directory

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