Company report

Industrials
Construction & Engineering
Equity – China

HSBC Global Research

China State Construction (3311 HK)

OW: Solid 2H14 result and a better 2015

- **FY14 net profit +25.7% YoY to HKD3,457m in line with market expectation.**
- **Catalysts could be higher new contract flow in 2015 than guidance and potential asset injection from parent company**
- **Maintain OW; no change to TP of HKD14.9 and earnings**

Maintaining the good track record of financial performance – The 2H14 financial performance was in line with the market and our expectations. It also met the company's guidance of at least 20% net profit growth. FY14 NPAT increased 25.7% YoY to HKD3,457m due to strong revenue growth of 26.2% in 2014. The company saw total new contracts grew 32.3% YoY to HKD60bn in 2014 and has guided for a conservative growth of 13% to HKD68bn in 2015. We forecast +16% new contract growth in 2015 and we think there is potential upside risk from Hong Kong projects and Chinese infrastructure and affordable housing projects. The company has a backlog of HKD101bn as at February 2015, which covers revenue by about 2.3 years. While the company did not provide any update the timing of potential asset injection from its major shareholder (China State Construction Engineering Corp 601668 CH, not rated) during the analyst briefing, we think it is a potential catalyst for the share price in 2015.

Good quality company at a reasonable price – CSCI is one of our preferred Chinese infrastructure stocks trading at 8.9x FY15 PER with 34% FY15e earnings growth. We think the company has a better new contract growth outlook than its Chinese construction company peers. It also has a solid track record of financial performance delivery, a high ROE of over 20% and a well-managed balance sheet.

Index^	HSCEI
Index level	12,122
RIC	3311.HK
Bloomberg	3311 HK

Source: HSBC

Enterprise value (HKDm)	43,418
Free float (%)	43
Market cap (USDm)	5,543
Market cap (HKDm)	43,013

Source: HSBC

Overweight

Target price	(HKD)	14.90
Share price	(HKD)	10.72
Potential return (%)		39

Dec	2013 a	2014 e	2015 e
HSBC EPS	0.70	0.90	1.21
HSBC PE	15.3	11.9	8.9

Performance	1M	3M	12M
Absolute (%)	-3.9	-4.8	-8.8
Relative^ (%)	-4.4	-10.5	-29.6

Potential return equals the percentage difference between the current share price and the target price, including the forecast dividend yield when indicated.

21 March 2015

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Financials & valuation

Financial statements

Year to	12/2013a	12/2014e	12/2015e	12/2016e
Profit & loss summary (HKDm)				
Revenue	27,192	34,628	44,886	48,143
EBITDA	3,423	4,566	6,210	7,425
Depreciation & amortisation	-400	-434	-473	-516
Operating profit/EBIT	3,023	4,132	5,737	6,909
Net interest	-283	-379	-506	-736
PBT	3,193	4,248	5,774	6,768
Taxation	-499	-757	-1,048	-1,236
Net profit	2,772	3,560	4,774	5,580
Cash flow summary (HKDm)				
Cash flow from operations	3,538	-1,981	-1,846	2,628
Capex	-548	-618	-698	-788
Cash flow from investment	-3,127	-218	-298	-388
Dividends	-700	-920	-1,235	-1,663
Change in net debt	1,351	1,215	3,379	-577
Balance sheet summary (HKDm)				
Intangible fixed assets	7,158	6,946	6,742	6,544
Tangible fixed assets	11,892	22,245	32,956	43,460
Current assets	19,602	23,224	25,007	27,994
Cash & others	8,116	8,901	6,522	8,099
Total assets	42,573	57,931	70,363	83,851
Operating liabilities	17,554	26,399	31,146	33,764
Gross debt	12,637	14,637	15,637	16,637
Net debt	4,521	5,736	9,115	8,538
Shareholders funds	16,181	16,316	23,049	32,968
Invested capital	12,982	17,115	27,037	36,135

Ratio, growth and per share analysis

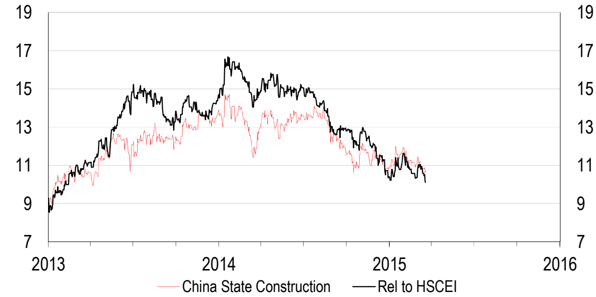
Year to	12/2013a	12/2014e	12/2015e	12/2016e
Y-o-y % change				
Revenue	24.1	27.3	29.6	7.3
EBITDA	28.3	33.4	36.0	19.6
Operating profit	32.6	36.7	38.9	20.4
PBT	25.6	33.1	35.9	17.2
HSBC EPS	24.5	28.4	34.1	16.9
Ratios (%)				
Revenue/IC (x)	2.0	2.3	2.0	1.5
ROIC	19.2	22.6	21.3	17.9
ROE	18.7	21.9	24.3	19.9
ROA	7.6	7.7	8.1	8.0
EBITDA margin	12.6	13.2	13.8	15.4
Operating profit margin	11.1	11.9	12.8	14.4
EBITDA/net interest (x)	12.1	12.1	12.3	10.1
Net debt/equity	27.5	34.8	39.3	25.8
Net debt/EBITDA (x)	1.3	1.3	1.5	1.1
Per share data (HKD)				
EPS reported (fully diluted)	0.70	0.90	1.21	1.41
DPS	0.21	0.27	0.37	0.43
Book value	4.16	4.20	5.93	8.48

Valuation data

Year to	12/2013a	12/2014e	12/2015e	12/2016e
EV/sales	1.6	1.3	1.0	0.9
EV/EBITDA	12.8	9.5	7.5	6.2
EV/IC	3.4	2.5	1.7	1.3
PE*	15.3	11.9	8.9	7.6
P/Book value	2.6	2.6	1.8	1.3
Dividend yield (%)	2.0	2.6	3.4	4.0

Note: * = Based on HSBC EPS (fully diluted)

Price relative



Source: HSBC

Note: price at close of 19 Mar 2015

A good company that delivers

- Solid 2H14 earnings were in line with expectation and cash flow continues to show improvement
- Analyst briefing focus on company's future growth via PPP model in China and overseas potential
- Maintain OW, TP of HKD14.9 and earnings forecast

2H14 results summary and key takeaway from analyst briefing

Key takeaway from analyst briefing

- **Participation in PPP (public and private partnership)**

  - A lot of questions on CSCI's intention to participate in a PPP (public-private partnership) model in Chinese infrastructure project development. State Council has been promoting the use of the PPP model as a way to manage the growth in local government debt. The PPP model would reduce the reliance on BT (build-transfer) project financing, which is classified as local government debt.

  - CSCI is committed to focus on a total return of at least 12% IRR to decide whether a PPP project would be suitable for investment. Potential return is more important than considering greenfield or brownfield projects, or the type of asset (such as toll road, port or logistics park asset). The management noted that it would be more in favour of participating in a greenfield PPP project that could generate better returns than brownfield projects due to profit from construction stage as well as the operation of the project after completion. In addition, the initial capital outlay for a brownfield project would be much bigger than greenfield, which could be financed over several years. We think this management comment could be related to the fact that the current financial gearing (net debt to equity) is about 36.8%, which is close to the company's target gearing level of no more than 40%.

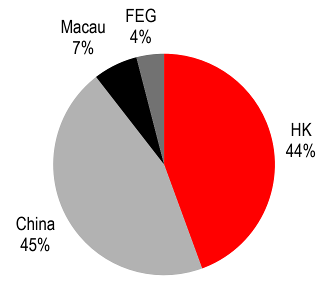
  - The company does not think its existing BT projects would be turned into PPP projects and it expects the BT project repayment to increase in 2015.

- **Overseas potential and how CSCI could benefit from "one road, one belt" policy**
  - The "one road, one belt" policy consists of the domestic and overseas portions. CSCI will focus more on the domestic portion of the one road one belt policy, especially in the central and western part of China. For the overseas portion, CSCI plans to leverage off its parent company, China State Construction Engineering Corp (601668 CH, not rated). The company did not provide an update on potential asset injection from parent company during the analyst briefing.
- **Profitability outlook**
  - The company expects profitability for Hong Kong and Macau operation to recover in 2015 due to construction progress. The normalised gross profit margin for Hong Kong project is about 7-8% and Macau is normally around 8%. CSCI achieved gross profit margin of 23% for China in 2014 and could have upside from the operation business of BOT projects.

Solid 2H14 earnings as expected

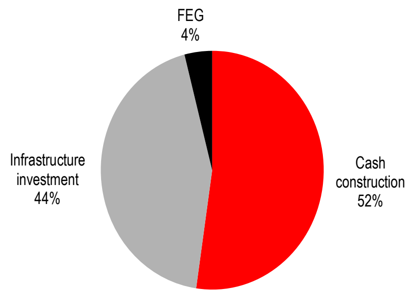
The company FY14 revenue increased 26.2% YoY to HKD34,440m and net profit increased +26% YoY to HKD3,457m in line with expectation (vs consensus of HKD3,466m and HSBC forecast of HKD3,560m). The 2H14 profitability of the company was held back by Hong Kong and Macau due to construction progress of MGM Cotai Project and several Hong Kong projects. This saw the 2H14 gross profit margin declined to 13.6% versus 14% in 1H14. The construction progress has since picked up and the company expects profitability for Hong Kong and Macau to recover in 2015. 2H14 profitability was softer than 1H14 due to slow progress of Macau project (MGM Casino development). We think Macau is a timing issue, which may see profitability recover in 1H15.

Revenue breakdown in 2014 by geography



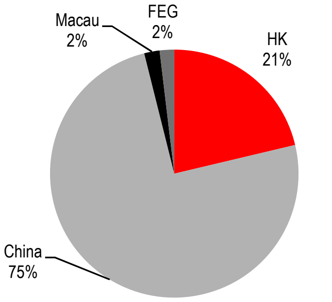
Source: Company data

Revenue breakdown by business



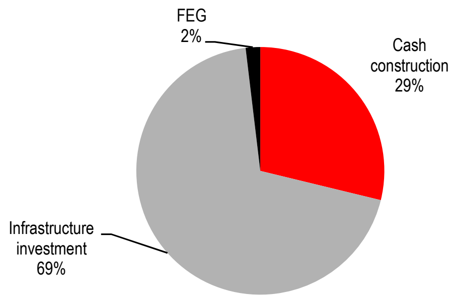
Source: Company data

Gross profit breakdown by geography 2014



Source: Company data

Gross profit breakdown by business



Source: Company data

The company maintained a steady dividend payout ratio of about 30% in 2014 and declared a final cash dividend of HKD15 cents (plus the 2014 interim dividend of HKD11 cents to bring the total dividend to be HKD26 cents). The company intends to maintain a similar level of payout in 2015.

CSCI – 2H14 results summary

HKDm	1H14	2H14	2014a	2013a	YoY%	HSBC est	var%
Revenue	**14,259**	**20,181**	**34,440**	**27,286**	**26.2%**	**34,628**	**-0.5%**
Cost of sales	(12,257)	(17,439)	(29,696)	(23,540)	26.2%	(29,799)	-0.3%
Gross profit	**2,002**	**2,741**	**4,743**	**3,746**	**26.6%**	**4,829**	
GP margin	*14.0%*	*13.6%*	*13.8%*	*13.7%*		*13.9%*	
Other income and other gains	267	208	475	437	8.9%	420	13.2%
Administrative expenses	(380)	(519)	(899)	(960)	-6.3%	(1,006)	-10.6%
Distribution, selling and other expenses	(42)	(92)	(134)	(83)	61.4%	(111)	20.8%
Profit/(loss) from operations [EBIT]	**1,846**	**2,339**	**4,185**	**3,140**	**33.3%**	**4,132**	**1.3%**
EBIT margin	*12.9%*	*11.6%*	*12.2%*	*11.5%*	*5.6%*	*11.9%*	
Finance costs	(265)	(191)	(456)	(418)	8.9%	(379)	20.3%
Share of profits (losses) of associates	14	10	24	22	8.4%	22	8.4%
Share of profits (losses) of JCEs	172	123	294	430	-31.6%	473	-37.8%
Profit before tax	**1,767**	**2,281**	**4,048**	**3,174**	**27.5%**	**4,248**	
Income tax expenses	(313)	(347)	(660)	(503)	31.1%	(757)	-12.8%
Net profit after tax	**1,454**	**1,934**	**3,388**	**2,671**	**26.9%**	**3,491**	**-3.0%**
Attributable to:							
Equity holder of the Company	1,465	1,992	3,457	2,750	25.7%	3,560	-2.9%
Minority interests	(11)	(58)	(70)	(79)	-11.8%	(69)	1.3%
EPS (HKD)	0.38	0.51	0.89	0.71	25.5%	0.92	-3.5%

Source: Company data and HSBC estimates

Financial performance by geography and business

(RMBm)	Revenue			Gross profit			GP margin		
	1H14	2H14	FY14	1H14	2H14	FY14	1H14	2H14	FY14
Hong Kong	6,248	9,037	15,285	393	618	1,011	6.3%	6.8%	6.6%
Mainland China	6,428	9,089	15,517	1,489	2,086	3,575	23.2%	23.0%	23.0%
Macau	969	1,287	2,256	62	34	96	6.4%	2.6%	4.3%
Overseas	-	-	-	(1)	(27)	(28)	na	na	na
FEG group	614	768	1,382	58	30	88	9.5%	3.9%	6.4%
Overall	**14,259**	**20,181**	**34,440**	**2,002**	**2,741**	**4,743**	**14.0%**	**13.6%**	**13.8%**

Source: Company data

Cash flow improving

The company net debt to equity increased from 28% in FY13 to 37% in FY14, which is now close to the company's target of no more than 40%. Operating cash flow was negative HKD1,689m and is an improvement on last year's negative HKD3,085m.

The total new contract awarded in FY14 was HKD60.4bn with 32% YoY growth. A conservative guidance for 2015 new contract of +13%YoY to HKD68bn announced in January 2015, which we think should have upside risk. CSCI sees growing use of prefabrication in affordable housing as offering new growth and may actively participate in the PPP project model with Chinese local government. The company also noted it expects several large scale projects to be launched in 2H15.

Upside risk for new contract growth in 2015

The company's 2015 total new contract guidance is HKD68bn or +13% growth YoY. For February 2015 YTD, CSCI has already secured HKD13.95bn of new projects or about 20.5% of the 2015 guidance.

We believe there is upside risk for the new contract growth in 2015, which would come from Hong Kong infrastructure projects and Chinese affordable housing projects, especially in cash construction with the use of pre-fabrication projects.

The company thinks it has a competitive advantage in the increased usage of pre-fabrication in construction. CSCI has two manufacturing plants in Shenzhen and Anhui Province to cater for the new market.

Hong Kong is likely to kick off a few large scale infrastructure projects in the coming 6-12 months, such as the third runway project for Hong Kong Airport. The project cost is estimated to be an over HKD140bn investment project and we think CSCI is well positioned to capture a portion of the large project. Hong Kong's Executive Council approved the construction plan in March 2015 with an expected completion date by 2023. We think this project could be tendered in stages in late 2015 and 2016. We suspect this project is not yet included in the market's forecast.

In addition, the Hong Kong government is looking to speed up the construction of public housing projects and increase supply. The government also plans to invest HKD81bn on hospital projects with 2,800 additional hospital beds. Over the medium-to-long term, there will be seven new subway/railway lines to be constructed in Hong Kong with an investment estimated at over HKD110bn.

Valuation and risks

We value the company using the residual income method. We use a cost of equity of 10.7%, based on a risk-free rate of 3.5%, a market risk premium of 6.5% and a beta of 1.1, and a terminal growth rate of 3%. Our target price is HKD14.9.

Under our research model, for stocks without a volatility indicator, the Neutral band is 5ppts above and below the hurdle rate for China stocks of 9%. The potential return is 39%, which is above the Neutral band; therefore, we reiterate the Overweight rating. Potential return equals the percentage difference between the current share price and the target price, including the forecast dividend yield when indicated.

Key downside risks include: Slowdown in Macau new contract growth, profitability declines in affordable housing projects, and investment risk related to asset injection from the parent company.

Disclosure appendix

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Important disclosures

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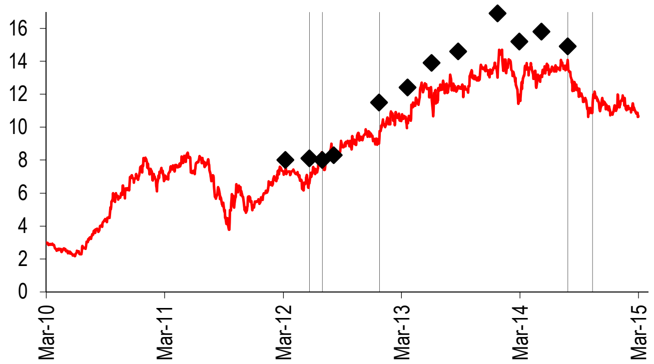
As of 20 March 2015, the distribution of all ratings published is as follows:

Overweight (Buy)	41%	(30% of these provided with Investment Banking Services)
Neutral (Hold)	39%	(28% of these provided with Investment Banking Services)
Underweight (Sell)	20%	(20% of these provided with Investment Banking Services)

Share price and rating changes for long-term investment opportunities

China State Construction (3311.HK) Share Price performance HKD Vs HSBC rating history



Source: HSBC

Recommendation & price target history

From	To	Date
Neutral (V)	Overweight (V)	08 June 2012
Overweight (V)	Neutral (V)	18 July 2012
Neutral (V)	Overweight	10 January 2013
Overweight	Neutral	14 August 2014
Neutral	Overweight	29 October 2014
Target Price	**Value**	**Date**
Price 1	8.00	26 March 2012
Price 2	8.10	08 June 2012
Price 3	8.00	18 July 2012
Price 4	8.30	22 August 2012
Price 5	11.50	10 January 2013
Price 6	12.40	07 April 2013
Price 7	13.90	20 June 2013
Price 8	14.60	10 September 2013
Price 9	16.90	10 January 2014
Price 10	15.20	18 March 2014
Price 11	15.80	25 May 2014
Price 12	14.90	14 August 2014

Source: HSBC

HSBC & Analyst disclosures

Disclosure checklist

Company	Ticker	Recent price	Price Date	Disclosure
CHINA STATE CONSTRUCTION	3311.HK	10.64	20-Mar-2015	4, 6, 11

Source: HSBC

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