

China State Construction

Lowering PT to HK\$18 - Results in line but debts continue to grow

China State Construction (CSC) is one of the largest contractors for affordable housing (AH) in China and one of the largest builders in HK/Macau. While the results are in line with expectations and new contract growth remains very strong, the share price is still depressed due to the relatively high level of debt and uncertainty on how CSC is going to fund such strong growth in build transfer (BT) projects. We are maintaining OW but lowering the PT to HK\$18.

- **Still strong core earnings.** We suggest buying on any dips related to concerns over new equity issuance. While the ND/E at Dec 2014 is at a record high and higher than the previous comfort level of 40-60% as mentioned by management, it is by no means unmanageable. Even a small amount of potential new equity (3-5% of MCAP) would bring the ND/E to below 50%. We focus on the strong earnings CAGR of over 25% (14-17) supported by contracts already signed.
- **Minor adjustment to earnings forecasts and lowering PT to HK\$18.** Our earnings estimates are relatively unchanged following the FY14 results. The key change is higher EBIT assumption and also higher interest expense to be consistent with the performance in 2014. Our 2015 and 2016 EPS estimates are 6% and 10% higher than consensus (Bloomberg). We lower our DCF-based Dec15 PT to HK\$18 (prev. HK\$20) to reflect the estimate changes.
- **CSC trades at 8.9x FY15E P/E.** Our DCF-based PT (Dec-15) of HK\$18.0 implies FY16E P/E of 15.1x and FY16E P/B of 3.0x. Key risks are falling construction activity in China and lower-than-expected returns on long-term projects in China. Another risk would be a shortage of workers or a hike in raw materials that could crimp margins

Overweight

3311.HK, 3311 HK

Price: HK\$10.64

▼ **Price Target: HK\$18.00**
Previous: HK\$20.00

Hong Kong

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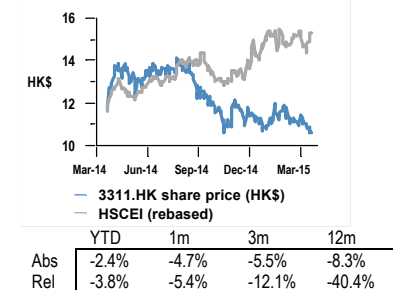
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Price Performance



China State Construction (Reuters: 3311.HK, Bloomberg: 3311 HK)

HK\$ in mn, year-end Dec	FY12A	FY13A	FY14A	FY15E	FY16E
Revenue (HK\$ mn)	19,765	27,192	34,440	47,214	68,471
Net Profit (HK\$ mn)	2,101	2,772	3,457	4,683	6,015
EPS (HK\$)	0.56	0.70	0.88	1.19	1.53
DPS (HK\$)	0.16	0.21	0.26	0.35	0.45
Revenue growth (%)	20.7%	37.6%	26.7%	37.1%	45.0%
EPS growth (%)	31.1%	25.9%	25.0%	35.5%	28.4%
ROCE	9.9%	8.9%	8.9%	10.8%	12.0%
ROE	18.3%	18.7%	19.2%	21.8%	23.8%
P/E (x)	19.1	15.1	12.1	8.9	7.0
P/BV (x)	3.0	2.6	2.1	1.8	1.5
EV/EBITDA (x)	20.2	17.2	14.3	10.4	8.6
Dividend Yield	1.5%	1.9%	2.4%	3.3%	4.2%

Source: Company data, Bloomberg, J.P. Morgan estimates.

Company Data

Shares O/S (mn)	3,540
Market Cap (HK\$ mn)	37,662
Market Cap (\$ mn)	4,855
Price (HK\$)	10.64
Date Of Price	20 Mar 15
Free Float(%)	35.0%
3M - Avg daily vol (mn)	6.60
3M - Avg daily val (HK\$ mn)	74.53
3M - Avg daily val (\$ mn)	9.6
HSCEI	12,156.40
Exchange Rate	7.76
Price Target End Date	31-Dec-15

See page 12 for analyst certification and important disclosures, including non-US analyst disclosures.

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Key catalysts for the stock price:	Upside risks to our view:	Downside risks to our view:
<ul style="list-style-type: none"> Monthly new contract wins continue to beat budget Continual margin expansion Better credit conditions for the local govts customers in China 	<ul style="list-style-type: none"> Stronger growth in new projects compared to company targets Entry into new construction sectors such as subways and other high end infrastructure works More large project wins in Macau (we currently don't factor in much) 	<ul style="list-style-type: none"> Falling construction activity in China especially in affordable housing Lower than expected returns on long term projects in China Late collections for government relate receivables

Key financial metrics	FY13A	FY14A	FY15E	FY16E
Revenues (LC)	27,192	34,440	47,214	68,471
Revenue growth (%)	37.6%	26.7%	37.1%	45.0%
EBITDA (LC)	3,325	4,369	6,254	7,852
EBITDA margin (%)	12.2%	12.7%	13.2%	11.5%
Tax rate (%)	16%	16%	17%	17%
Net profit (LC)	2,772	3,457	4,683	6,015
EPS (LC)	0.702	0.878	1.190	1.528
EPS growth (%)	25.9%	25.0%	35.5%	28.4%
DPS (LC)	0.21	0.26	0.35	0.45
BVPS (LC)	4.16	5.10	5.95	7.04
Operating cash flow (LC mn)	(2,975)	1,929	1,038	1,096
Free cash flow (LC mn)	(2,998)	701	130	(417)
Interest cover (x)	12	15	8	13
Net margin (%)	10.2%	10.0%	9.9%	8.8%
Sales/assets (X)	0.62	0.59	0.65	0.77
Debt/equity (%)	105.8%	111.3%	104.0%	95.2%
Net debt/equity (%)	56.4%	74.0%	73.0%	72.1%
ROE (%)	19%	19%	22%	24%

Key model assumptions	FY13A	FY14A	FY15E	FY16E
Sales from Hong Kong	44%	48%	35%	33%
Sales from Macau	1%	7%	8%	10%
Sales from China	45%	56%	57%	57%

Source: Company and J.P. Morgan estimates.

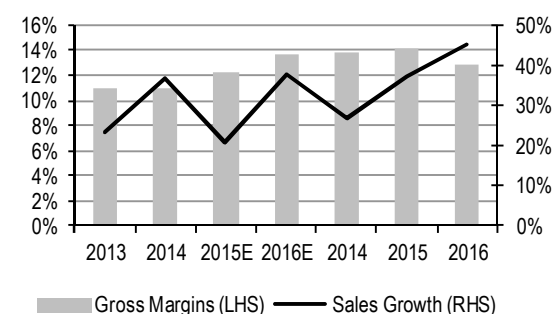
Sensitivity analysis	EBITDA		EPS	
	FY15E	FY16E	FY15E	FY16E
Sensitivity to				
1% chg in HK margins	3%	3%	4%	4%
5% chg in China Construction	3%	3%	4%	5%
1% chg in China BT margins	4%	5%	5%	6%

Source: J.P. Morgan estimates.

Valuation and price target basis

Our Dec-15 price target is based on a DCF valuation that assumes a market risk premium of 6.0% and a risk free rate of 4.2%. We have assumed Beta to 1.2 (a little more conservative than the current Bloomberg Beta is 1.3).

GPM trends



Source: Company, J.P. Morgan estimates.

JPMe vs. consensus, change in estimates

EPS (LC)	FY15E	FY16E
JPMe old	1.20	1.55
JPMe new	1.19	1.53
% chg	-1%	-2%
Consensus	1.12	1.38

Source: Bloomberg, J.P. Morgan estimates.

Peer Comparisons

Company Name	Code	Price (TP) Local ccy	MCAP US\$MM	Vol US\$m	1W Chg	3M Chg	14 P/E (x)	15e PE(x)	ROE (%)	P/B (x)	Yld (%)
CSC (OW)	3311 HK	10.64 (18)	5,473	8.6	(1.8)	(0.7)	12.1	8.9	18.7	2.6	2.4
CHINA RAIL OW	390 HK	6.49 (8.3)	31,950	21.2	6.4	6.6	10.4	9.0	11.8	1.2	1.5
CHINA COM - OW	1800 HK	9.63 (13.7)	33,461	44.6	3.9	1.5	8.8	8.1	14.2	1.2	2.7
CHINA RLY CONST - OW	1186 HK	9.87 (14.4)	29,053	19.1	6.7	1.6	8.3	7.3	13.6	1.0	1.9
SAMSUNG ENG - UW	028050 KS	39550 (31000)	1,415	38.9	11.7	4.4	2.6	2.1	20.7	1.7	1.0
HYUNDAI ENG OW	000720 KS	51300 (56000)	5,111	31.0	7.2	20.4	9.2	8.1	16.0	1.6	1.0
					5.7	5.6	8.6	7.3	15.8	1.5	1.8

Source: Bloomberg, J.P. Morgan estimates. Share prices are as of close of Mar 20, 2015

Highlights from analysts briefing

- **Margins continue to rise for BT.** While sales from BT (affordable housing and infrastructure) were lower than expected due to slower-than-expected completion rates, the rise in GPM was much better than we had expected. Each year, we expect a drop in GPM in the following year that hasn't come to fruition. In 2014, GPM for affordable housing BT rose from 18.5% in 2013 to 20.1% in 2014 and the GPM on infrastructure BT rose from 21.7% in 2013 to 22.2% in 2014. We note that management is comfortable with BT projects with IRR over 12% (which we estimate can be easily achieved with projects with GPM >15%). We are still conservatively factoring in a drop in GPM on BT projects to 18-19% for 2015 and 2016.
- **Management is still comfortable with the debt level.** Management calculates the company's Dec14 ND/E at 37% which includes all ST and LT interest bearing debts but does not include debt associated with projects that are held for disposal. This debt amounted to HK\$7.4bn as at Dec14 or approx 37% of equity. As these are interest bearing debts (with recourse to CSC) as at Dec14, we have included them in our ND/E calculation (74% at Dec 2014). We do stress that management's comfort level is based on their calculation of ND/E (excluding debts related to assets to be disposed). However, this large debt item would continue to cause concerns over new equity issuance unless the company can demonstrate that these assets are being disposed and the related debts extinguished.
- **Delays in clearing debts due to approvals.** One of the largest components of the debt associated with assets to be disposed (classified as "liabilities directly associated with assets classified as held for sale") is related to CSC's largest BT project in China, the Shanxi road, which was completed in late 2013. CSC had made an arrangement with the provincial government to reallocate the bank debts associated with this project (we est. HK\$5-6bn) from CSC to the government. The accounting treatment of this is an asset disposal (the asset is CSC's claim to the provincial government) and effectively the payment is the deletion of an equivalent amount of bank debt. This is a large sum and requires the approval of various levels of governments, which CSC believed it could have received before Dec14 but was unable to do so. The company has reassessed the situation with its auditors and still believes that this category of debt related to assets held for disposal would be resolved before Dec15 (the reported 2014 results suggest the auditors have agreed and classified these items as short term).
- **Government commercial housing re-purchase not a big concern.** Management highlights that the repurchases of commercial housing as AH is not a big concern. On one hand, the proportion of re-purchases as a percentage of total AH projects is not high. On the other hand, there are many problems associated with this action, such as high purchases costs, limited sources of commercial houses, etc. The government's support for new construction of affordable housing and shantytown redevelopment is still very strong and the repurchase measures could happen alongside new AH construction. In fact, the government has announced the target of shanty town redevelopment target of 7.44mn in 2015 (7mn in 2014 and 6.17mn in 2013).

FY14 result overview

Table 2: FY14 results

FY results (HK\$m)	FY13	FY14	Y/Y	FY14E	Var	Consensus
Turnover*	27,192	34,440	26.7%	35,329	-2.5%	34,221
Gross profit	3,735	4,743	27.0%	5,068	-6.4%	4,894
GPM*	13.7%	13.8%		14.3%		14.30%
EBIT	3,171	4,503	42.0%	4,199	7.2%	3,935
EBITM	11.7%	13.1%		11.9%		11.5%
Net profit	2772	3,457	24.7%	3,579	-3.4%	3,452
EPS	0.70	0.89	26.3%	0.91	-2.5%	0.89

Source: Company, J.P. Morgan estimates

Table 2: Breakdown of new contracts

(HK \$bn)	FY14	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
New Contract Awarded													
BT Investment	37.83	3.97	0.00	0.98	4.67	4.18	0.00	3.95	4.38	4.45	3.75	7.5	0.00
Affordable Housing	27.26	3.97	0.00	0.98	4.67	0.00	0.00	2.35	2.50	1.54	3.75	7.5	0.00
Infrastructure	10.57	0.00	0.00	0.00	0.00	4.18	0.00	1.60	1.88	2.91	0.00	0	0.00
Cash Construction & Related	20.45	14.95	2.23	0.06	0.02	0.09	2.53	0.01	0.06	0.04	0.03	0.01	0.42
PRC	0.83	0.01	0.57	0.05	0.02	0.02	0.01	0.00	0.03	0.03	0.02	0.01	0.06
Hong Kong	9.14	4.46	1.66	0.01	0.00	0.07	2.52	0.01	0.03	0.01	0.01	0	0.36
Macau	10.48	10.48	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0	0
Far East Global	1.96	0.00	0.00	0.68	0.00	0.00	0.45	0.00	0.00	0.53	0.00	0	0.30
Total	60.24	18.92	2.23	1.72	4.69	4.27	2.98	3.96	4.44	5.02	3.78	7.51	0.72

Source: Company data

Table 3: Project in process as of Dec 2014

HK\$bn	As of Dec 2014	
	Total Value	Backlog
BT Investment	81.82	50.84
Affordable Housing	49.93	35.23
Infrastructure	31.89	15.61
Cash Construction & Related	74.41	39.68
PRC	1.47	0.57
Hong Kong	58.99	28.31
Macau	13.95	10.8
Far East Global	3.77	2.58
Total	160.00	93.1

Source: Company data

- FY14 revenue reported 26.7% y/y growth and roughly in line with our estimate. We also see some positive improvement in EBITM from 11.7% in FY13 to 13.1% in FY14 thanks to the drop in administrative expenses as a proportion of revenue from 3.5% to 2.6%. This is a good example of how strong sales growth does not necessarily mean higher admin costs, which are relatively fixed and well controlled. CSC also saw a slightly growth in GPM as driven by the increase in sales revenue. NP reported 24.7% y/y growth, which is 3.4% lower than our estimates.
- In FY14, CSC reported 35% y/y growth in new contracts to HK\$60.24bn, beating its 2014 target of HK\$55bn by 11%, which is mainly driven by MGM casino

project. The company's 2015 target for new contracts is HK\$68bn (up 13% Y/Y from actual 2014 new contracts and up 23% from the target for 2014 set in Jan 2014), which compares with our estimate of HK\$71bn of new contracts. We are comfortable with our estimate being 4.4% higher than the company's target as the target set at the beginning of each year has been beaten by ~5% in the previous two years.

BT projects summary

Table 4: BT contracts

Name/location	Date signed	Housing	INFRA	% stake	Total*	First payment
South Staion / Taiyuan	Jan-11		2.8	60%	1.7	Dec-13
Hechaun Dist. / Chongqing	Feb-11	2.0		100%	2.0	Apr-13
Zhangzhou City , Fujian	Apr-11	1.8		100%	1.8	Dec-13
Zhangzhou City , Fujian	Apr-11		1.2	100%	1.2	Dec-13
Wuyu Expressway	Jun-11		7.2	100%	7.2	Dec-14
Xiaoshan , Hangzhou relocation	Jul-11	0.7		100%	0.7	1Q14
Huishan, Wuxi relocation	Jul-11	2.0		100%	2.0	1Q14
Hangzhou, Xiaoshan district (Beigan St)	Oct-11	1.1		100%	1.1	1Q14
Hangzhou, Xiaoshan district (Xintang St)	Oct-11	1.7		100%	1.7	1Q14
Total for 2011		9.3	11.1		19.3	
2nd Wuhan road, Wuhan	Jan-12		0.40	100%	0.4	Sep-14
East Lake Passageway, Wuhan	Feb-12		2.3	100%	2.3	Dec-14
Zhangzhou , Fujian	Apr-12	3.0		100%	3.0	Jun-14
Lucheng, Wenzhou, Zhejiang	Aug-12	3.0		100%	3.0	>2014
Tieshan Street, Lushunjou, Dalian	Oct-12	2.5		100%	2.5	>2014
Total for 2012		8.5	2.7		11.2	
Jingkou District, Zhenjiang, Jiangsu	Jan-13	1.63		100%	1.6	>2014
Lucheng District , Wenzhou , Zhejiang	Apr-13	4.5		100%	4.5	>2014
Xinmi 323 & Gongyi 327, Zhengzhou, Henan	May-13		4.9	100%	4.9	>2014
Lucheng District (Ph 3) , Wenzhou , Zhejiang	Jun-13	4.5		100%	4.5	>2015
Dalu Yaoqiao, Zhejiang	Sep-13	2.8		100%	2.8	>2016
Litong Street , Xian , Shanxi	Oct-13	2.5		100%	2.5	>2016
Pinghu, Jiaxing, Zhejiang	Nov-13	1.6		100%	1.6	>2016
YTD Total for 2013		17.6	4.9		22.5	
Pingyang County , Wenzhou Zhejiang	Jan-14	4.0		100%	4.0	>2016
Shushan District Ind Park , Hefei m Anhui	Mar-14			100%		>2016
Ph 2 Pinghu Jiaxing City , Zhejiang	Apr-14	1.0		100%	1.0	>2016
National Highway G104 , Fuzhou	May-14	4.7		100%	4.7	>2016
Zhengzhou , Henan	Jul-14	-	4.2	100%	4.2	>2016
Wuhan East Lake , Hubei	Jul-14	2.35		100%	2.4	>2016
Wuhan River Avenue	Jul-14		1.1	100%	1.1	>2016
Chengyang District , Qingdao	Aug-14		0.5	100%	0.5	>2016
Ph2 Qujiang, Xian, Shaanxi	Aug-14	2.50		100%	2.5	>2016
Ph 2 Zhengzhou , Henan	Sep-14		1.9	100%	1.9	>2016
5 Infra , Wuhan , Hubei	Sep-14	1.55		100%	1.6	>2016
Wuxing District , Huzhou Zhejiang	Oct-14		2.9	100%	2.9	>2016
Huangyan District - Taizhou, Zhejiang	Nov-14	3.80		100%	3.8	>2016
2014		7.50	10.6	100%	7.5	
Dayang, Luyang District , Hefei, Anhui	Feb-15	27.3		100%	37.9	
Longhai, Zhangzhou , Fujian		1.3		100%	1.3	
YTD 2015			2.6	100%	2.6	
Target for 2015		1.3	2.6		3.8	
Total 2011 - 2015		91.36	42.30		41.7	

Source: Company data; * attributable stake ** early repayments received or expected

Net profits estimates adjusted down 1.1% for FY15 and 1.6% for FY16

CSC: Earnings estimates revision

Year to Dec (HK\$m)	----- New -----		----- Old -----		----- Change -----	
	FY15E	FY16E	FY15E	FY16E	FY15E	FY16E
Turnover*	47,214	68,471	48,899	66,833	-3.4%	2.5%
Gross profit	6,673	8,805	6,711	8,917	-0.6%	-1.3%
EBIT	5,819	7,371	5,540	7,234	5.0%	1.9%
Net profit	4,683	6,015	4,735	6,112	-1.1%	-1.6%
EPS	1.190	1.528	1.203	1.552	-1.1%	-1.6%
Assumptions						
New BT signed (bn)	41.7	42.9	37.36	38.48	11.6%	11.6%
Gross margin	14.1%	12.9%	13.7%	13.3%	0.4%	-0.5%

Source: J.P. Morgan estimates

As the 2014 results were only slightly lower than our estimates for sales and net profits, we make only some minor changes to our estimates. The key change is a higher EBIT assumption and higher interest expense which was the case in 2014. Our 2015 and 2016 EPS estimates are 6% and 10% higher than consensus (Bloomberg). We lower our DCF based Dec15 PT to HK\$18 (prev. HK\$20) to reflect the estimate changes. We also cut our longer term growth assumption as the higher than expected level of debt as at Dec 14 may cause management to take on fewer new projects than they could have with a lower debt level.

Valuation and share price analysis

DCF Valuation

Our Dec-15 price target is based on a DCF valuation that assumes a market risk premium of 6.0% and a risk free rate of 4.2% (yield on 10-year government notes in China). We have assumed Beta of 1.2. Accordingly, WACC is assumed at 10.2%. We have estimated free cash flow for CSC until FY20 and assume a terminal growth rate of 3.0%. The terminal growth is based on the annual growth rate expected in FY20 (the final year of the estimate period) subject to a minimum of 3% and a maximum of 6% depending on the nature of the industry and the level of maturity in China.

We also analyzed the DCF price sensitivity to WACC, and the terminal multiple.

Table 5: CSC – Base-case DCF analysis

	2013	2014E	2015E	2016E	2017E	2018E	2019E	Terminal
Cash flow estimates								
Sales	27,192	34,440	47,214	68,471	72,179	79,132	81,552	84,335
EBIT	3,023	4,030	5,819	7,371	7,566	7,851	7,911	7,873
NOPAT	2,837	3,555	5,253	6,379	6,486	6,737	6,805	6,795
Capex, net	(262)	(1,480)	(1,570)	(1,996)	(1,206)	(609)	(664)	(980)
Depreciation	302	339	434	481	523	551	579	603
Change in working capital	(5,915)	(1,940)	(4,556)	(5,828)	(1,661)	901	822	(353)
Free operating CF (FoCF)	(3,037)	473	(439)	(964)	4,141	7,579	7,542	6,066
DCF Parameters			Assumptions					
Liabilities as a% of EV	20%							Terminal growth
WACC	10.2%							Risk-free rate
Enterprise NPV (10E-16E)	84,149							Market risk
+ Net cash (debt), current	(17,015)							Beta
- Minorities (Market value)	0							Cost of debt
+/- Other items	0							Implied exit P/E multiple (x)
= Equity value	67,134							13
/ Number of shares	3,837							
= Equity value per share (HK\$)	18.0							

Source J.P. Morgan estimates, Company data.

Table 6: CSC – Sensitivity analysis based on WACC and perpetual terminal growth rate

		Terminal growth rate						
		1.5%	2%	2.5%	3.0%	3.5%	4.0%	4.5%
WACC	8.7%	19.3	20.3	21.5	22.9	24.5	26.5	28.9
	9.2%	17.8	18.7	19.6	20.8	22.1	23.7	25.6
	9.7%	16.5	17.2	18.0	19	20.1	21.3	22.9
	10.2%	15.3	15.9	16.6	18.0	18.3	19.4	20.6
	10.7%	14.2	14.8	15.4	16	16.8	17.7	18.7
	11.2%	13.3	13.7	14.2	14.8	15.5	16.2	17.1
	11.7%	12.4	12.8	13.2	13.7	14.3	14.9	15.6

Source: J.P. Morgan estimates; Company data.

Financial analysis

Table 7: CSC – Revenue Mix

	2012	2013A	2014A	2015E	2016E
HK +FEG	10,364	12,475	16,587	16,713	22,756
YoY	19.0%	20.4%	33.0%	0.8%	36.2%
% of sales	52.4%	45.9%	48.2%	35.4%	33.2%
China	597	0	0	0	0
YoY	-63.9%				
% of sales	3.0%	0.0%	0.0%	0.0%	0.0%
Others (Dubai, India,etc)	15	16	0	0	0
YoY					
% of sales	0.1%	0.1%	0.0%	0.0%	0.0%
Macau	860	837	2,256	4,000	7,000
YoY	253.7%	-2.7%	169.7%	77.3%	75.0%
% of sales	4.3%	3.1%	6.6%	8.5%	10.2%
BT related contracts	6,529	12,398	14,097	24,423	36,445
YoY	21.3%	89.9%	13.7%	73.3%	49.2%
% of sales	33.0%	45.6%	40.9%	51.7%	53.2%
Other revenues	1,399	1,466	1,500	2,078	2,271
YoY	172.7%	4.8%	2.4%	38.5%	9.3%
% of sales	7.1%	5.4%	4.4%	4.4%	3.3%
Total	19,765	27,192	34,440	47,214	68,471
YoY	20.7%	37.6%	26.7%	37.1%	45.0%

Source: Company data, J.P. Morgan estimates.

Table 8: CSC – P&L statement

Year to Dec (HK\$ MM)	2012	2013	2014	2015E	2016E
Total Revenues	19,765	27,192	34,440	47,214	68,471
YoY change (%)	20.7%	37.6%	26.7%	37.1%	45.0%
Cost of Goods Sold	-17,355	-23,457	-29,697	-40,541	-59,666
YoY change (%)	19.0%	35.2%	26.6%	36.5%	47.2%
Gross Profit	2,410	3,735	4,743	6,673	8,805
YoY change (%)	34.0%	55.0%	27.0%	40.7%	32.0%
Gross Margin	12.2%	13.7%	13.8%	14.1%	12.9%
SGA	(770)	(1,017)	(1,033)	(1,345)	(1,951)
YoY change (%)	33.5%	31.9%	1.6%	30.2%	45.0%
Other Income/(Expenses)	656	305	320	492	517
Operating profit	2,295	3,023	4,030	5,819	7,371
EBITDA	2,538	3,325	4,369	6,254	7,852
EBITDA margin	12.8%	12.2%	12.7%	13.2%	11.5%
Depreciation & Amortization	(243)	(302)	(339)	(434)	(481)
YoY change (%)	17.5%	24.1%	12.4%	28.2%	10.8%
EBIT	2,295	3,023	4,030	5,819	7,371
EBIT margin	11.6%	11.1%	11.7%	12.3%	10.8%
Net Interest Expense	(171)	(283)	(456)	(975)	(759)
Exceptional item	0	0	0	0	0
Associates	436	452	318	488	344
Gains/losses	0	0	0	0	0
Net Income Before Taxes	2,492	3,193	4,048	5,511	7,130
YoY change (%)	35.1%	28.1%	26.8%	36.1%	29.4%
Tax	(385)	(499)	(660)	(928)	(1,242)
Effective Tax rate	18.1%	18.1%	18.1%	18.1%	18.1%
Minority Interests	(5)	79	70	100	127
Net Income	2,101	2,772	3,457	4,683	6,015
YoY change (%)	39.4%	31.9%	24.7%	35.5%	28.4%
Net margin	10.6%	10.2%	10.0%	9.9%	8.8%

Source: Company data, J.P. Morgan estimates.

Table 9: Interim estimates

Year to Dec (HK\$ MM)	1H13	2H13	1H14	2H14	1H15E	2H15E
Total Revenues	10,896	16,296	14,258	20,182	19,546	27,667
Gross Profit	1,374	2,361	2,002	2,741	2,816	3,857
EBIT	1,343	1,680	1,923	2,107	2,484	3,335
Net Income Before Taxes	1,397	1,795	1,767	2,281	2,353	3,158
Net Income	1,173	1,599	1,465	1,992	1,999	2,684
Diluted EPS (HK\$)	0.297	0.405	0.372	0.503	0.508	0.682
Ratios						
Revenue split	40.1%	59.9%	41.4%	58.6%	41.4%	58.6%
GPM	12.6%	14.5%	14.0%	13.6%	14.4%	13.9%
EBIT margin	12.3%	10.3%	13.5%	10.4%	12.7%	12.1%
NPM	10.8%	9.8%	10.3%	9.9%	10.2%	9.7%
YoY						
Revenue	21.6%	50.8%	30.9%	23.8%	37.1%	37.1%
GP	36.7%	68.1%	45.7%	16.1%	40.7%	40.7%
EBIT	41.4%	24.9%	43.2%	25.4%	29.2%	58.3%
NP	32.2%	31.7%	24.9%	24.6%	36.5%	34.7%

Source: Company data, J.P. Morgan estimates

Table 10: CSC – Balance sheet

Year to Dec (HK\$ MM)	2012	2013	2014	2015E	2016E
Cash and Cash Equivalents	6,717	8,116	7,452	7,240	6,355
Inventories	185	163	160	220	319
Accounts receivable	6,560	8,655	12,901	17,686	25,649
Other Current Assets	6,976	10,932	13,816	20,455	25,442
Total Current Assets	20,438	27,865	34,330	45,600	57,766
Intangible Assets	0	0	0	0	0
Property and Equipment, Net	2,191	2,342	2,827	2,930	3,125
Other Assets	14,584	20,629	26,085	31,250	37,851
Non-Current assets	16,775	22,971	28,912	34,180	40,976
Total Assets	37,213	50,836	66,579	79,781	98,742
Accounts Payable	7,718	10,468	17,261	23,664	34,318
Other Accrued Expenses	4,114	4,906	5,004	5,896	7,119
Taxes Payable	595	606	931	1,199	1,513
ST and current LT debts	49	4,984	8,025	8,746	9,467
Total Current Liabilities	12,475	20,964	31,221	39,504	52,418
Long-term Debt	9,996	12,400	14,230	15,509	16,788
Other Noncurrent Liability	0	0	0	0	0
Noncurrent liabilities	10,884	13,438	15,360	16,953	18,732
Total Liabilities	23,360	34,402	46,581	56,457	71,150
Share capital	97	97	100	100	100
Reserves and Surplus	13,413	16,084	19,730	23,039	27,289
Total Shareholders' Equity	13,510	16,181	19,830	23,139	27,389
Minority Interest	343	253	168	184	203
Total Shareholders' Equity	13,853	16,434	19,998	23,323	27,592
Total Liabilities and Equity	37,213	50,836	66,579	79,781	98,742

Source: Company data, J.P. Morgan estimates.

Investment Thesis, Valuation and Risks

China State Construction *(Overweight; Price Target: HK\$18.00)*

Investment Thesis

China State Construction (CSC) is one of the largest contractors in Hong Kong and the largest contractor for affordable housing in China. CSC combines the benefits of international construction experience with access to the resources of the parent group, China State Construction and Engineering Corp, the largest contractor for buildings in China. New government policy to promote the construction of affordable housing is a key growth driver for CSC. “Build-Transfer (BT)” projects are used for the construction of affordable housing and infrastructure in China. This relatively new type of contract has higher margins than traditional cash contracts because they require contractors to fund projects during the construction period and are repayable to the contractor for the two- to three-year period after completion.

Valuation

Our Dec-15 price target is based on a DCF valuation that assumes a market risk premium of 6.0% and a risk free rate of 4.2% (yield on 10-year government notes in China). We have assumed Beta of 1.0. Accordingly, WACC is assumed at 10.2%. We have estimated free cash flow for CSC until FY20 and assume a terminal growth rate of 3.0%. The terminal growth is based on the annual growth rate expected in FY20 (the final year of the estimate period) subject to a minimum of 3% and a maximum of 6% depending on the nature of the industry and the level of maturity in China.

Risks to Rating and Price Target

The key downside risks to our PT include falling construction activity in China and lower-than-expected returns on long-term projects in China.

China State Construction: Summary of Financials

Income Statement						Cash flow statement					
HK\$ in millions, year end Dec	FY13	FY14	FY15E	FY16E	FY17E	HK\$ in millions, year end Dec	FY13	FY14	FY15E	FY16E	FY17E
Revenues	27,192	34,440	47,214	68,471	72,179	EBIT	3,023	4,030	5,819	7,371	7,566
% change Y/Y	37.6%	26.7%	37.1%	45.0%	5.4%	Depr. & amortization	302	339	434	481	523
Gross Profit	3,735	4,743	6,673	8,805	9,069	Change in working capital	(5,915)	(1,940)	(4,556)	(5,828)	(1,661)
% change Y/Y	55.0%	27.0%	40.7%	32.0%	3.0%	Taxes	(385)	(499)	(660)	(928)	(1,242)
EBITDA	3,325	4,369	6,254	7,852	8,088	Cash flow from operations	(2,975)	1,929	1,038	1,096	5,185
% change Y/Y	31.0%	31.4%	43.1%	25.6%	3.0%	Capex	(262)	(1,480)	(1,570)	(1,996)	(1,206)
EBIT	3,023	4,030	5,819	7,371	7,566	Net Interest	(283)	(301)	(797)	(585)	(757)
% change Y/Y	31.7%	33.3%	44.4%	26.7%	2.6%	Other	362	255	488	344	291
EBIT Margin	11.1%	11.7%	12.3%	10.8%	10.5%	Free cash flow	(2,998)	701	130	(417)	4,601
Net Interest	(283)	(301)	(797)	(585)	(757)	Equity raised/(repaid)	0	0	0	0	0
Earnings before tax	3,193	4,048	5,511	7,130	8,173	Debt raised/(repaid)	4,992	0	2,000	2,000	0
% change Y/Y	28.1%	26.8%	36.1%	29.4%	14.6%	Other	0	0	0	0	0
Tax	(499)	(660)	(928)	(1,242)	(1,448)	Dividends paid	(699)	(912)	(1,193)	(1,570)	(1,888)
as % of EBT	15.6%	16.3%	16.8%	17.4%	17.7%	Beginning cash	6,717	8,116	7,452	7,240	6,355
Net income (reported)	2,772	3,457	4,683	6,015	6,855	Ending cash	8,116	7,452	7,240	6,355	7,827
% change Y/Y	31.9%	24.7%	35.5%	28.4%	14.0%	DPS	0.21	0.26	0.35	0.45	0.51
Shares outstanding	3,946	3,937	3,937	3,937	3,937						
EPS (reported)	0.70	0.88	1.19	1.53	1.74						
% change Y/Y	25.9%	25.0%	35.5%	28.4%	14.0%						
Balance sheet						Ratio Analysis					
HK\$ in millions, year end Dec	FY13	FY14	FY15E	FY16E	FY17E	HK\$ in millions, year end Dec	FY13	FY14	FY15E	FY16E	FY17E
Cash and cash equivalents	8,116	7,452	7,240	6,355	7,827	Gross margin	13.7%	13.8%	14.1%	12.9%	12.6%
Accounts receivable	8,655	12,901	17,686	25,649	27,038	EBITDA margin	12.2%	12.7%	13.2%	11.5%	11.2%
Inventories	163	160	220	319	336	Operating margin	11.1%	11.7%	12.3%	10.8%	10.5%
Others	10,932	13,816	20,455	25,442	28,078	Net margin	10.2%	10.0%	9.9%	8.8%	8.1%
Current assets	27,865	34,330	45,600	57,766	63,279	Sales per share growth	31.2%	26.9%	37.1%	45.0%	5.4%
LT investments	20,629	26,085	31,250	37,851	41,350	Sales growth	37.6%	26.7%	37.1%	45.0%	5.4%
Net fixed assets	2,342	2,827	2,930	3,125	3,109	Net profit growth	31.9%	24.7%	35.5%	28.4%	14.0%
Total Assets	50,836	66,579	79,781	98,742	107,738	EPS growth	25.9%	25.0%	35.5%	28.4%	14.0%
Liabilities						Interest coverage (x)	11.8	14.5	7.9	13.4	10.7
Short-term loans	4,984	8,025	8,746	9,467	9,467	Net debt to equity	56.4%	74.0%	73.0%	72.1%	56.8%
Payables	10,468	17,261	23,664	34,318	36,176	Working Capital to Sales	25.4%	9.0%	12.9%	7.8%	9.5%
Others	5,512	5,935	7,095	8,632	10,780	Sales/assets	0.6	0.6	0.6	0.8	0.7
Total current liabilities	20,964	31,221	39,504	52,418	56,423	Assets/equity	3.0	3.3	3.4	3.5	3.5
Long-term debt	12,400	14,230	15,509	16,788	16,788	ROE	18.7%	19.2%	21.8%	23.8%	19.6%
Other liabilities	1,038	1,130	1,444	1,945	2,072	ROCE	8.9%	8.9%	10.8%	12.0%	11.1%
Total Liabilities	34,402	46,581	56,457	71,150	75,282						
Shareholders' equity	16,181	19,830	23,139	27,389	32,233						
BVPS	4.16	5.10	5.95	7.04	8.29						

Source: Company reports and J.P. Morgan estimates.

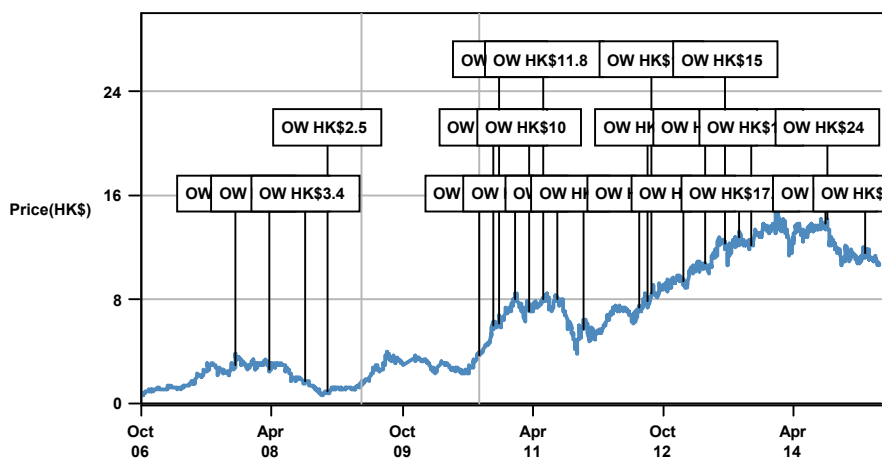
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China State Construction (3311.HK, 3311 HK) Price Chart



Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends. Initiated coverage Oct 29, 2007.

Date	Rating	Share Price (HK\$)	Price Target (HK\$)
29-Oct-07	OW	2.85	4.75
19-Mar-08	OW	2.65	4.25
20-Aug-08	OW	1.66	3.40
18-Nov-08	OW	0.86	2.50
17-Aug-10	OW	3.73	5.50
20-Oct-10	OW	5.93	7.80
09-Nov-10	OW	6.14	9.00
13-Jan-11	OW	7.94	11.00
18-Mar-11	OW	7.00	10.00
13-May-11	OW	8.00	11.80
11-Jul-11	OW	8.02	11.00
25-Oct-11	OW	5.75	10.00
20-Jun-12	OW	7.42	11.00
19-Jul-12	OW	7.88	12.00
08-Aug-12	OW	8.40	13.00
19-Dec-12	OW	9.43	11.00
21-Mar-13	OW	10.78	13.00
13-Jun-13	OW	12.38	15.00
15-Aug-13	OW	12.82	17.50
30-Sep-13	OW	12.18	19.00
10-Aug-14	OW	13.80	22.00
14-Aug-14	OW	14.08	24.00
23-Jan-15	OW	11.56	20.00

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