

# Beijing Enterprises Water (371 HK)

## Buy

Target price (HKD)	6.60
Share price (HKD)	5.10
Upside/Downside (%)	29.4

Dec	2013 a	2014 e	2015 e
HSBC EPS	0.14	0.20	0.26
HSBC PE	36.5	25.1	19.4
Performance	1M	3M	12M
Absolute (%)	5.8	-3.4	-1.0
Relative <sup>A</sup> (%)	8.4	-3.8	-16.8

31 March 2015

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Issuer of report: The Hongkong and Shanghai Banking Corporation Limited

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This report must be read with the disclosures and the analyst certifications in the Disclosure appendix, and with the Disclaimer, which forms part of it

Buy: Strong FY14 and promising 2015

- **Strong FY14 beat consensus by 10%, although in line with HSBC**
- **Upside risk to 3.0mtpd capacity addition guidance and potential Yieldco establishment in 2015**
- **Establish Buy rating on robust EPS growth beating consensus and potential re-rating from Yieldco; set fair value TP of HKD6.60**

**Strong FY14 results:** Beijing Enterprises Water (BEW) reported strong results after market close on 30 March. Net income reached HKD1.8bn, up 65% y-o-y and beating consensus by 10% (in line with HSBC). The company declared a final dividend of HKD4.8 cents per share (dividend yield of 0.9%) and the full-year payout ratio was 38%.

Revenue was only HKD8.9bn in 2014, less than our forecast and driven by slower-than-expected revenue recognition for water environment renovation and also lower revenue from sewage treatment. Income from associates and other income and gains were stronger than expected, driven by water plant construction commencement and asset disposal gains. Minority interests as % of profit after tax reached 13% in 2014, higher than that of 5% in 2013. All other items were in line with our estimates.

BEW has net-added water capacities of 3.4mtpd in 2014 and total water capacities reached 20.2mtpd by end-2014.

**Bullish on 2015:** Management guides for 3.0mtpd of capacity addition in 2015, although they also highlight upside risk as BEW is now following 164 water projects with total capacities of 20.1mtpd. Management expects most of the projects to be in Eastern China and expects 70% of capacity addition to come in the form of new BOT (which generates higher return than M&A). In addition, management expects the parent to inject the water assets of Golden State Environment Group, although there is no timing on the potential injection. BEW expects total capacity to reach 40.0mtpd by 2018.

Management stated that it hopes to establish a Yieldco in 2015 in order to reduce potential earnings dilution risk, and that BEW may be able to raise as much as USD500m from the Yieldco in 2015, at interest rates of below 5%.

**Establish Buy:** We establish a Buy rating on BEW with a fair value TP of HKD6.60. We like BEW on its robust earnings growth beating consensus (from capacity, price and environment renovation projects) and potential re-rating from a Yieldco as we believe this could mitigate and potentially even eliminate equity placement risk due to reduced EPS dilution risk.

Index <sup>A</sup>	HSCEI
Index level	11,898
RIC	0371.HK
Bloomberg	371 HK

Source: HSBC

Enterprise value (HKDm)	62,006
Free float (%)	34
Market cap (USDm)	5,726
Market cap (HKDm)	44,411

Source: HSBC

## Financials & valuation

### Financial statements

Year to	12/2013a	12/2014e	12/2015e	12/2016e
<b>Profit &amp; loss summary (HKDm)</b>				
Revenue	6,406	8,926	12,034	13,685
EBITDA	1,865	3,211	3,727	4,517
Depreciation & amortisation	-122	-183	-221	-254
Operating profit/EBIT	1,743	3,028	3,505	4,263
Net interest	-354	-639	-508	-499
PBT	1,497	2,667	3,111	3,882
HSBC PBT	1,497	2,667	3,111	3,882
Taxation	-352	-594	-653	-815
Net profit	1,084	1,794	2,335	2,913
HSBC net profit	1,084	1,794	2,335	2,913

### Cash flow summary (HKDm)

Cash flow from operations	-936	-1,611	-439	-56
Capex	-2,380	-974	-767	-762
Cash flow from investment	-2,857	-1,595	-1,596	-1,779
Dividends	-346	-228	-313	-409
Change in net debt	4,786	3,630	3,557	2,742
FCF equity	-3,874	-3,797	-2,154	-1,840

### Balance sheet summary (HKDm)

Intangible fixed assets	2,523	2,286	3,637	4,046
Tangible fixed assets	379	1,243	600	700
Current assets	15,212	15,078	14,135	15,026
Cash & others	5,513	6,091	2,344	2,602
Total assets	46,710	53,926	57,710	63,687
Operating liabilities	8,979	9,062	11,923	12,444
Gross debt	19,283	23,490	23,300	26,300
Net debt	13,770	17,400	20,956	23,698
Shareholders funds	13,298	15,784	16,006	17,899
Invested capital	24,043	30,075	34,462	39,098

### Ratio, growth and per share analysis

Year to	12/2013a	12/2014e	12/2015e	12/2016e
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#### Y-o-y % change

Revenue	71.9	39.3	34.8	13.7
EBITDA	64.6	72.1	16.1	21.2
Operating profit	63.8	73.7	15.8	21.6
PBT	37.1	78.1	16.6	24.8
HSBC EPS	28.7	45.2	29.2	24.8

#### Ratios (%)

Revenue/IC (x)	0.3	0.3	0.4	0.4
ROIC	5.5	6.6	7.2	7.9
ROE	10.0	12.3	14.7	17.2
ROA	4.4	5.8	6.0	6.7
EBITDA margin	29.1	36.0	31.0	33.0
Operating profit margin	27.2	33.9	29.1	31.2
EBITDA/net interest (x)	5.3	5.0	7.3	9.0
Net debt/equity	103.6	110.2	130.9	132.4
Net debt/EBITDA (x)	7.4	5.4	5.6	5.2
CF from operations/net debt				

#### Per share data (HKD)

EPS reported (fully diluted)	0.14	0.20	0.26	0.33
HSBC EPS (fully diluted)	0.14	0.20	0.26	0.33
DPS	0.05	0.08	0.09	0.12
Book value	1.58	1.81	1.84	2.06

### Key forecast drivers

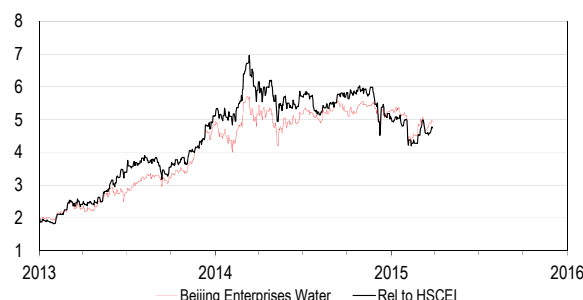
Year to	12/2013a	12/2014e	12/2015e	12/2016e
Treatment capacity in ops (ktp)	6,678	8,861	10,761	13,161
Treatment tariff (HKD/t)	1.2	1.2	1.3	1.4
Water construction GP (HKD m)	760	1,057	1,115	1,114
Water supply capacity in ops (	2,750	3,470	4,447	5,447
Water tariff (HKD/t)	2.5	2.3	2.3	2.3

### Valuation data

Year to	12/2013a	12/2014e	12/2015e	12/2016e
EV/sales	9.0	6.9	5.5	5.0
EV/EBITDA	31.0	19.3	17.6	15.2
EV/IC	2.4	2.1	1.9	1.8
PE*	36.5	25.1	19.4	15.6
P/Book value	3.2	2.8	2.8	2.5
FCF yield (%)	-8.8	-8.5	-4.8	-4.1
Dividend yield (%)	1.0	1.5	1.8	2.3

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

### Price relative



Source: HSBC

Note: price at close of 30 Mar 2015

## Strong FY14 results

Beijing Enterprises Water (BEW) reported strong FY14 results with net income reaching HKD1.8bn, up 65% y-o-y and beating consensus by 10% (in line with HSBC). Stripping out the equity-settled share option expenses, net income would have reached HKD1.9bn, up 60% y-o-y. The company declared a final dividend of HKD4.8 cents per share (dividend yield of 0.9%) and the full-year payout ratio was 38%.

Revenue was only HKD8.9bn in 2014, less than our forecast and driven by slower-than-expected revenue recognition for water environment renovation and also lower revenue from sewage treatment. Income from associates and other income and gains were stronger than our expectation, driven by construction commencement and disposal gains. Minority interests as % of profit after tax reached 13% in 2014, higher than that of 5% in 2013. All other items were in line with our estimates.

BEW has net-added water capacities of 3.4mtpd in 2014, after the net impact of securing 4.7mtpd of capacities, disposing of 0.7mtpd of capacities (in Shandong and Guizhou) and replacing 0.5mtpd of capacities in Luoyang (Henan). Total water capacities reached 20.2mtpd by end-2014 and management remains upbeat about business outlook in 2015.

### Income statement, HKDm

	2013	2014	YoY	2H13	1H14	2H14	YoY	HoH
Revenue	6,406	8,926	39%	3,643	3,816	5,110	40%	34%
COGS	3,901	5,430	39%	2,242	2,220	3,210	43%	45%
<b>Gross profit</b>	<b>2,506</b>	<b>3,496</b>	<b>40%</b>	<b>1,401</b>	<b>1,596</b>	<b>1,900</b>	<b>36%</b>	<b>19%</b>
Gross margin	39%	39%		38%	42%	37%		
Admin expenses	775	1,066	38%	505	479	587	16%	22%
% of revenue	12%	12%		14%	13%	11%		
Other op expenses	188	11	-94%	138	8	3	-98%	-62%
% of revenue	3%	0%		4%	0%	0%		
<b>Operating profit</b>	<b>1,543</b>	<b>2,419</b>	<b>57%</b>	<b>758</b>	<b>1,109</b>	<b>1,311</b>	<b>73%</b>	<b>18%</b>
Operating margin	24%	27%		21%	29%	26%		
Finance costs	(788)	(1,084)	38%	(446)	(519)	(565)	27%	9%
Interest income	434	446	3%	262	176	270	3%	53%
Associates & JVs	108	278	159%	113	84	195	73%	133%
Other revenue/(loss)	200	608	204%	123	138	470	283%	240%
<b>Profit before tax</b>	<b>1,497</b>	<b>2,667</b>	<b>78%</b>	<b>810</b>	<b>988</b>	<b>1,680</b>	<b>107%</b>	<b>70%</b>
Pre-tax margin	23%	30%		22%	26%	33%		
Tax (expenses)/credits	(352)	(594)	69%	(195)	(191)	(403)	107%	111%
<b>Profit after tax</b>	<b>1,145</b>	<b>2,073</b>	<b>81%</b>	<b>615</b>	<b>797</b>	<b>1,276</b>	<b>108%</b>	<b>60%</b>
Tax rate	23%	22%		24%	19%	24%		
Minority interests	61	279	356%	45	83	196	335%	136%
<b>Net income</b>	<b>1,084</b>	<b>1,794</b>	<b>65%</b>	<b>570</b>	<b>714</b>	<b>1,080</b>	<b>90%</b>	<b>51%</b>
Net margin	17%	20%		16%	19%	21%		

Source: Company data, HSBC estimates

Operations, HKDm								
	2013	2014	YoY	2H13	1H14	2H14	YoY	HoH
<b>Revenue</b>								
Sewage and reclaimed water treatment	2,141	3,250	52%	1,291	1,571	1,679	30%	7%
Water supply	384	813	112%	265	360	452	70%	26%
Construction for comprehensive renovation	2,882	2,125	-26%	1,545	418	1,707	11%	309%
Construction of water plants	882	2,458	179%	481	1,365	1,093	127%	-20%
Technical services for water environmental	118	281	139%	60	102	179	197%	76%
<b>Total</b>	<b>6,407</b>	<b>8,926</b>	<b>39%</b>	<b>3,643</b>	<b>3,816</b>	<b>5,110</b>	<b>40%</b>	<b>34%</b>
<b>Gross profit</b>								
Sewage and reclaimed water treatment	1,456	1,986	36%	912	977	1,009	11%	3%
Water supply	200	406	103%	111	179	227	105%	27%
Construction for comprehensive renovation	663	340	-49%	288	79	261	-10%	228%
Construction of water plants	97	590	508%	53	273	317	499%	16%
Technical services for water environmental	100	196	97%	51	86	110	117%	27%
<b>Total</b>	<b>2,506</b>	<b>3,496</b>	<b>40%</b>	<b>1,401</b>	<b>1,596</b>	<b>1,900</b>	<b>36%</b>	<b>19%</b>
<b>Gross margins</b>								
Sewage and reclaimed water treatment	68%	61%		71%	62%	60%		
Water supply	52%	50%		42%	50%	50%		
Construction for comprehensive renovation	23%	16%		19%	19%	15%		
Construction of water plants	11%	24%		11%	20%	29%		
Technical services for water environmental	85%	70%		84%	85%	61%		
<b>Overall</b>	<b>39%</b>	<b>39%</b>		<b>38%</b>	<b>42%</b>	<b>37%</b>		

Source: Company data, HSBC estimates

## Key takeaways from post-results conference call

- ▶ Out of BEW's 20.2mtpd of capacities by end-2014, 11.5mtpd was in operation and 2.4mtpd was under construction. Management expects construction for 2.1mtpd to be completed in 2015.
- ▶ Out of BEW's 326 water plants, 54% is under 1A discharge standard, 45% is under 1B standard and 1% is under No. 2 standard.
- ▶ Management guides for 3.0mtpd of capacity addition in 2015, although they also highlight upside risk due to the very big number of water project opportunities. Management expects most of the new projects to be in Eastern China and expects 70% of capacity addition to come in the form of new BOT.
- ▶ BEW is following 164 water projects with total capacities of 20.1mtpd. Although management expects the parent to inject the water assets of Golden State Environment Group, there is no timing on the potential injection. BEW expects total capacity to reach 40.0mtpd by 2018.
- ▶ BEW has completed discharge standard upgrades for 4 plants (280ktpd) in 2014, sees China accelerating upgrades and expects upgrades for no less than 5 plants (230ktpd) in 2015. According to past experiences, water tariffs usually rise by 30-40% after discharge standard upgrades.
- ▶ In addition, BEW raised water tariffs for 12 plants without having to go through discharge standard upgrade. Total capacities involved were 1.6mtpd and average tariffs rose by 14%.
- ▶ Management expects water treatment revenue to rise by 40-45% in 2015, water plant construction revenue to rise by 25-30%, water environment renovation revenue to rise by 60% and technical services revenue to rise by 30-40%. Management expects net income to rise by 30-35%.

- ▶ Gross margin for sewage treatment should be ~60% over the next few years. The margin declined from 68% in 2013 to 61% in 2014 as it was artificially high in 2013, driven by major repair fund provision reversal.
- ▶ Excluding Beijing 9th Water Plant, gross margin for water supply rose from 43% in 2013 to 50% in 2014. The margin declined from 52% in 2013 to 50% in 2014 as the impact from the very-high-margin Beijing 9th Water Plant was diluted with the increased number of water plants in 2014.
- ▶ Gross margin for water environment renovation should be ~15% over the next few years. The margin decline from 23% in 2013 to 16% in 2014 was driven by the high-margin Guizhou Nanminghe project in 2013.
- ▶ Income from associates and JVs rose significantly as Beijing 10th Water Plant recorded construction earnings after construction started. Other revenue rose significantly because of BT project sale.
- ▶ Management expects admin expenses as percentage of revenue to decline from 2015 as the company continues to lower labour costs (i.e. reduce the number of employees by sharing labour resources between near-by plants) after the acquisition of Standard Water.
- ▶ Average finance cost was 4.6% in 2014, up from 4.1% in 2013 but down from 4.9% in 1H14. Finance cost should average 4.6% in 2015.
- ▶ Net debt/equity ratio was 110% (or 91% if minority interests are included) by end 2014, lower than the level by 1H14 as the company collected substantial amount of receivables in 2H14. Cash balance was HKD6.1bn by end 2014, up from HKD4.8bn by 1H14. Management sees further room for debt financing.
- ▶ Total capex should be HKD7.6-8.0bn in 2015 and BEW will only have to put in equity investment of HKD4.5-4.8bn.
- ▶ Management stated that it hopes to establish a Yieldco in 2015 and that BEW may be able to raise as much as USD500m from the Yieldco in 2015 at interest rate of below 5%.
- ▶ BEW does not particularly like PPP projects package without bidding as management believes that such package usually contains some projects with poor returns.
- ▶ Management stated BEW is thinking of acquiring small-size industrial sewage companies in 2015 and also plans to enter the township water market. BEW did not enter into significant M&A in 2014 as a result of the very high price required by M&A targets.
- ▶ Receivables over 1-year were primarily from the Kunming project and cash collection has mostly been going as planned. Management expects lower receivables risk from governments with implementation of the new budget law.
- ▶ Negative goodwill was recognized in 2014 as its auditor believed that BEW acquired Standard Water at bargain.

## Valuation and risks

We set a fair value TP of HKD6.60. Our target price is based on a DCF valuation (risk-free rate of 3.0%, market risk premium of 6.5%, beta of 0.8, WACC of 6.0%, a 25-year DCF, no terminal value). We assume no terminal value in our DCF as BOT and TOT environmental projects should be transferred back to the government after the service concession period of c25 years.

**Key downside risks:** uncertainty over investment in solar PV, worsening local government financial conditions, slower-than-expected capacity expansion, difficulties with overseas operations, value-destructive M&A, and an equity placement at a substantial discount to the current share price.

# Disclosure appendix

## Analyst Certification

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### **From 23rd March 2015 HSBC has assigned ratings on the following basis:**

The target price is based on the analyst's assessment of the stock's actual current value, although we expect it to take six to 12 months for the market price to reflect this. When the target price is more than 20% above the current share price, the stock will be classified as a Buy; when it is between 5% and 20% above the current share price, the stock may be classified as a Buy or a Hold; when it is between 5% below and 5% above the current share price, the stock will be classified as a Hold; when it is between 5% and 20% below the current share price, the stock may be classified as a Hold or a Reduce; and when it is more than 20% below the current share price, the stock will be classified as a Reduce.

Our ratings are re-calibrated against these bands at the time of any 'material change' (initiation or resumption of coverage, change in target price or estimates).

Upside/Downside is the percentage difference between the target price and the share price.

### **Prior to this date, HSBC's rating structure was applied on the following basis:**

For each stock we set a required rate of return calculated from the cost of equity for that stock's domestic or, as appropriate, regional market established by our strategy team. The target price for a stock represented the value the analyst expected the stock to reach over our performance horizon. The performance horizon was 12 months. For a stock to be classified as Overweight, the potential return, which equals the percentage difference between the current share price and the target price, including the forecast dividend yield when indicated, had to exceed the required return by at least 5 percentage points over the succeeding 12 months (or 10 percentage points for a stock classified as Volatile\*). For a stock to be classified as Underweight, the stock was expected to underperform its required return by at least 5 percentage points over the succeeding 12 months (or 10 percentage points for a stock classified as Volatile\*). Stocks between these bands were classified as Neutral.

\*A stock was classified as volatile if its historical volatility had exceeded 40%, if the stock had been listed for less than 12 months (unless it was in an industry or sector where volatility is low) or if the analyst expected significant volatility. However, stocks which we did not consider volatile may in fact also have behaved in such a way. Historical volatility was defined as the past month's average of the daily 365-day moving average volatilities. In order to avoid misleadingly frequent changes in rating, however, volatility had to move 2.5 percentage points past the 40% benchmark in either direction for a stock's status to change.

## Rating distribution for long-term investment opportunities

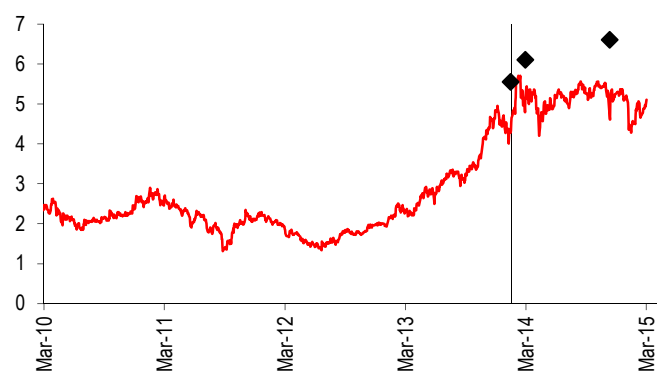
As of 30 March 2015, the distribution of all ratings published is as follows:

Buy	41%	(30% of these provided with Investment Banking Services)
Hold	39%	(28% of these provided with Investment Banking Services)
Sell	20%	(21% of these provided with Investment Banking Services)

For the purposes of the distribution above the following mapping structure is used during the transition from the previous to current rating models: under our previous model, Overweight = Buy, Neutral = Hold and Underweight = Sell; under our current model Buy = Buy, Hold = Hold and Reduce = Sell. For rating definitions under both models, please see “Stock ratings and basis for financial analysis” above.

## Share price and rating changes for long-term investment opportunities

Beijing Enterprises Water (0371.HK) Share Price performance HKD Vs HSBC rating history



Source: HSBC

Recommendation & price target history

From	To	Date
N/A	Overweight	12 February 2014
Target Price	Value	Date
Price 1	5.55	12 February 2014
Price 2	6.10	28 March 2014
Price 3	6.60	09 December 2014

Source: HSBC



## HSBC & Analyst disclosures

### Disclosure checklist

Company	Ticker	Recent price	Price Date	Disclosure
BEIJING ENTERPRISES WATER	0371.HK	5.10	30-Mar-2015	6

Source: HSBC

- 1 HSBC has managed or co-managed a public offering of securities for this company within the past 12 months.
- 2 HSBC expects to receive or intends to seek compensation for investment banking services from this company in the next 3 months.
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### Additional disclosures

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- 2 All market data included in this report are dated as at close 30 March 2015, unless otherwise indicated in the report.
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