

Company Report

BJ ENT WATER (371 HK)

Eye on M&A opportunities

- BEW reported in-line 1H18 core profit of HK\$2.3bn (+22% YoY)
- Mgmt. is eyeing on more M&A opportunities amid the tightening credit environment
- Reiterate BUY and TP at HK\$6.1

1H18 results in line

BEW's core profit came in at HK\$2.3bn, up 22% YoY, mainly driven by strong revenue growth in construction of BOT water projects (+17% YoY) and technical service (+90% YoY), and construction margin recovery for comprehensive renovation projects (mainly PPP projects) (+11ppts). An interim DPS of HK\$9.5 cents is declared, implying a payout ratio of 37%.

Maintain 2018 guidance unchanged

In 1H18, including those newly won tenders, BEW net added 3.3mtpd water treatment capacities. Mgmt. still maintains its full year newly added water treatment capacity at 4mtpd, which we think is conservative, as the co. is currently following 121 projects with a total water treatment capacity of 13.2mtpd. For PPP projects, given the co. adopting a more stringent risk-reward approach, the new projects generated a better return than old ones. Together with the construction reduction benefiting from its procurement of key materials, the gross margin of PPP project rebounded significantly from 15% in 1H17 to 26% in 1H18. Mgmt. expects that the construction margin can maintain stable at 26% going forward. So far, BEW has secured RMB17.7bn PPP projects, achieving 59% of its full year target of RMB30bn. The PPP projects secured in 2017 downsized from RMB54bn to RMB25bn as the co. intended to control its investment risks. Thus, mgmt. revises down the revenue growth for construction services from 13% to 10% and cut the capex from RMB16.5bn to RMB10bn in 2018. In view of the strong performance of technical services in 1H18, mgmt. raises the revenue growth for the segment from 12% to 40-50% in 2018. In all, mgmt. maintains the net profit growth at 20-25% YoY.

Well positioned for potential M&As

BEW's net gearing ratio decreased from 103% in 2017 to 95% in 1H18 thanks to its equity financing of HK\$3.7bn in Jan 2018. As of 30 Jun 2018, BEW had HK\$13.6bn cash. Mgmt. is eyeing plenty of M&A opportunities in the near future given that the tightening credit environment will force those distressed water companies out of market. The improving balance sheet allows BEW to consolidate the market. Mgmt. aims to increase its market share from the existing 7.3% to 15-20% in the mid-long term.

Financials

Year ended 31 Dec HK\$ mn	2016	2017	2018E	2019E	2020E
Revenue	17,355	21,192	24,504	27,681	30,792
Gross profit	5,785	6,465	7,493	8,526	9,676
Reported net profit	3,227	3,717	4,375	5,114	5,939
Recurring net profit	2,707	3,582	4,375	5,114	5,939
Recurring EPS (HK\$)	0.30	0.40	0.46	0.53	0.62
Core P/E (x)	13.8	10.5	9.2	7.9	6.8
P/B (x)	2.2	1.8	1.7	1.5	1.3
Dividend Yield (%)	2.8	3.7	4.3	5.0	5.8
ROE (%)	19.7	19.9	19.7	20.4	20.9
Net debt / equity (%)	93.8	102.8	95.5	100.1	100.4

Sources: Company data, CMS (HK) estimates

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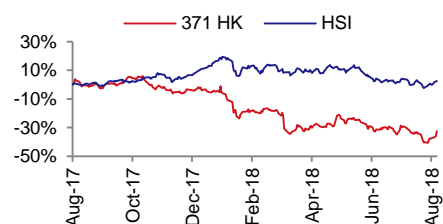
WHAT'S NEW

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BUY

Previous Rating	BUY
Price	HK\$4.21
12-month Target Price (Potential up/downside)	HK\$ 6.10 (+44.9%)
Previous Target Price	HK\$6.10

Price Performance



Source: Bloomberg

%	1m	6m	12m
371 HK	(4.5)	(16.2)	(32.4)
HSI	(1.3)	(7.9)	2.3

Sector: Environmental Protection

Hang Seng Index	28,416
HSCEI	11,083

Key Data

52-week range (HK\$)	3.61-6.645
Market cap (HK\$ mn)	39,627
Avg. daily volume (mn)	17.05
BVPS (HK\$) (2018E)	2.51

Shareholding Structure

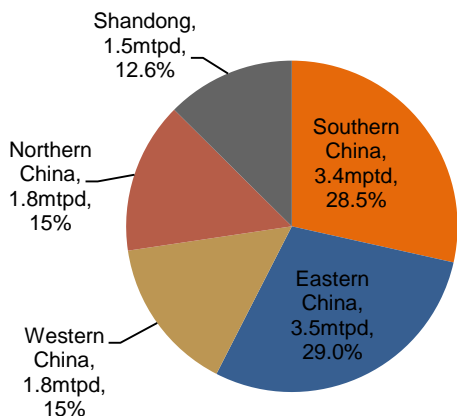
Beijing Enterprises Group	42.4%
Min Zhou	3.3%
Pictet Funds	2.4%
BNP Paribas	2.4%
No. of shares outstanding (mn)	9,413
Free float (mn)	5,109

Related Research

1. China water sector - Over the rainbow 2018/04/23
2. BJ ENT WATER (371 HK) - Headwinds of PPP policy leads a slower FY 18 NP growth 2018/03/29
3. BJ ENT WATER (371 HK) - 2017 preview: strong project pipelines support growth 2018/03/15
4. China water sector - Bottom up - rerate is not far away for quality players 2018/01/24

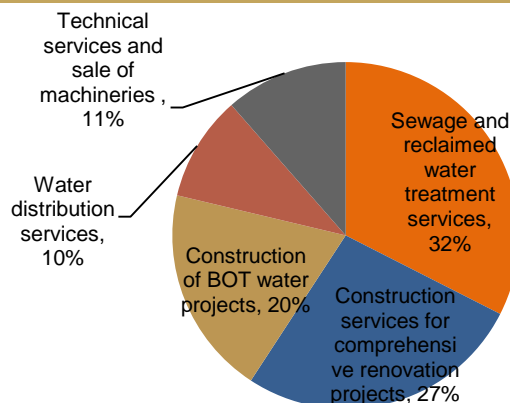
Focus charts

Figure 1: BEW – Sewage and reclaimed water treatment projects allocation in China in 1H2018



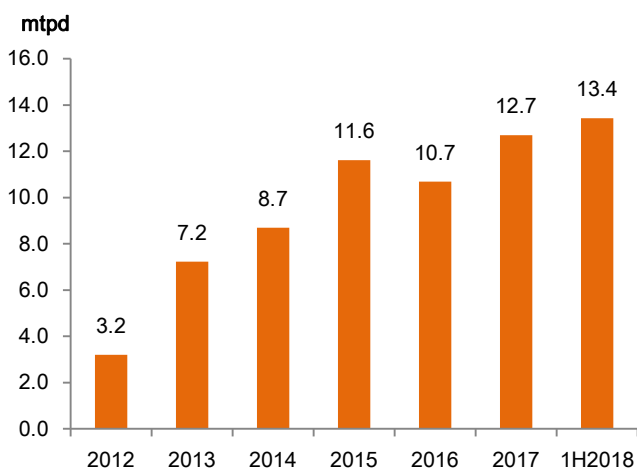
Sources: Company data, CMS (HK)

Figure 2: BEW – 1H2018 net profit breakdown



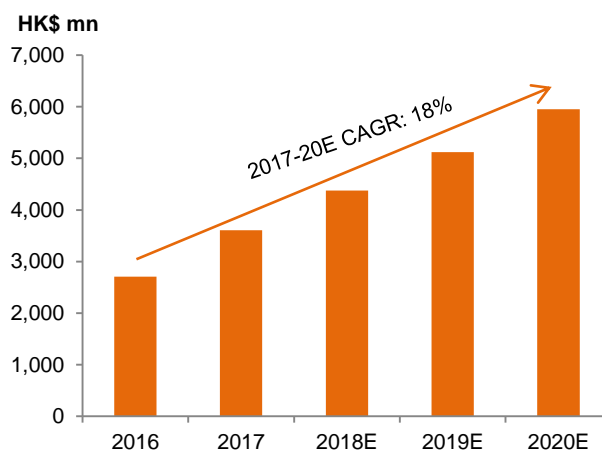
Sources: Company data, CMS (HK)

Figure 3: BEW – Capacities not yet commenced /transferred



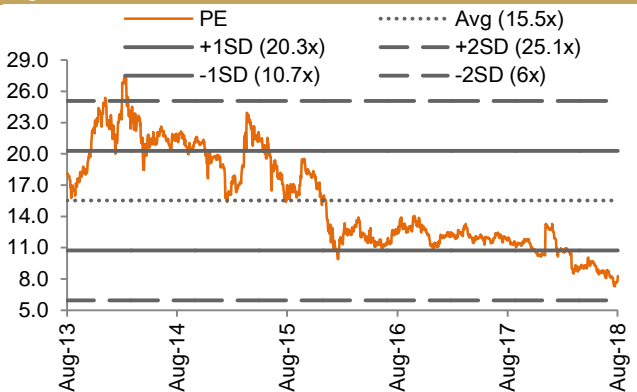
Sources: Company data, CMS (HK)

Figure 4: BEW – Core profit forecasts



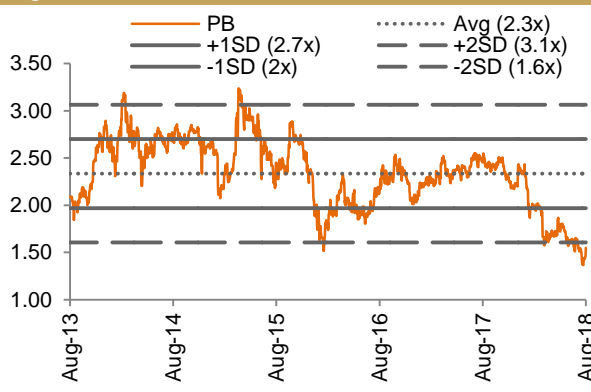
Sources: Company data, CMS (HK) estimates

Figure 5: BEW – 12-month blended forward P/E



Sources: Bloomberg, CMS (HK) estimates

Figure 6: BEW – 12-month blended forward P/B



Sources: Bloomberg, CMS (HK) estimates

1H2018 results review

Figure 7: BEW – 1H2018 results highlights

HK\$ mn	20171H	20181H	% change	Comments
Revenue	9,126	10,009	9.7%	17%/21%/90% YoY revenue growth in construction of BOT water projects, water distribution services and technical services and sales of machine, respectively, more than offset 15% YoY revenue decline in construction services for comprehensive renovation projects
Cost of sales	(6,069)	(6,175)	1.8%	
Gross profit	3,057	3,834	25.4%	1) Gross margin improvement in construction services for comprehensive renovation projects; 2) shifted in revenue mix to high margin technical services and sales of machineries
<i>Gross margin</i>	33.5%	38.3%	+4.8ppts	
Other income and gains, net	434	724	66.9%	Including HK\$138mn of VAT refund, HK\$88mn of pipeline installation income, HK\$77.3 mn sludge treatment income and HK\$61mn of government grants and subsidies in 1H18
Administrative expenses	(755)	(884)	17.1%	Staff costs increased due to business expansion
Other operating expenses	(162)	(83)	-49.1%	Lowered by the reduction in FX loss
Operating profit	2,573	3,590	39.5%	
<i>Operating margin</i>	28.2%	35.9%	+7.7ppts	
Interest income	122	214	75.5%	Cash increased due to equity placement in Jan 2018
Finance costs	(698)	(836)	19.8%	Due to increase in bank and other borrowings and market interest rate
Share of results of associates & JV	615	411	-33.2%	Mainly due to the conversion of JV to subsidiaries as a result of acquiring additional interest in JV
Fair value gain on derivative financial instruments	40	-	-100.0%	
Profit before tax	2,652	3,379	27.4%	
Income tax expense	(499)	(609)	22.1%	
Profit after taxation	2,153	2,770	28.6%	
Non-controlling interests	(123)	(278)	126.1%	
Holders of perpetual capital instruments	(116)	(127)	8.6%	
Net profit	1,914	2,366	23.6%	
<i>Net margin</i>	21.0%	23.6%	+2.6ppts	
Recurring net profit	1,884	2,301	22.1%	Mainly excl. FX gain of HK\$58mn in 1H18 and fair value gain on derivative financial instruments of HK\$40mn in 1H17
<i>Recurring net margin</i>	20.6%	23.0%	+2.4ppt	
Basic EPS (HK\$)	0.2188	0.2556	16.8%	Grew slower than core profit due to dilution from equity placement in Jan 2018
Diluted EPS (HK\$)	0.2142	0.2518	17.6%	
Interim DPS (HK\$)	0.08	0.095	18.8%	
Other financial data (HK\$ mn)				
Total cash & cash equivalent	7,537	12,985	72.3%	Equity placement and bond issuance
Total debt	37,789	49,376	30.7%	Issuance of panda bond of RMB3bn
Net debt (cash)	30,252	36,392	20.3%	
Shareholders' fund	29,557	38,477	30.2%	
Net debt (cash) / equity	102.4%	94.6%	-7.8ppts	
Operating data				
<u>Sewage and reclaimed water treatment operation</u>				
Daily designed capacity in operation (mn tons)				
- China	10.87	11.95	9.9%	0.8mtpd was completed construction during 1H2018
- Overseas	0.43	0.60	41.1%	Boosted by its acquired project in Australia
Average daily processing volume (mn tons)	9.14	10.05	9.9%	
Average daily treatment rate (%)	85%	87%	+2.0ppts	
Average contracted tariff - China (RMB per ton)	1.06	1.09	2.8%	
Daily designed capacity not yet commenced operation/not yet transferred (mn tons)	6.91	8.10	17.3%	secured 2.6mtpd in 1H2018
<u>Water distribution</u>				
Daily designed capacity in operation (mn tons)				
- China	5.89	6.54	11.1%	
- Overseas	0.04	1.21	3253.1%	Boosted by its acquired project in Australia
Average contracted tariff - China (RMB per ton)	1.91	2.09	9.4%	
Daily designed capacity not yet commenced operation/not yet transferred (mn tons)	5.47	5.28	-3.4%	

Sources: Company data, CMS (HK)

Figure 8: BEW – 1H2018 key financial highlights by segment

	20171H	20181H	% change	Comments
Turnover by segment (HK\$ mn)				
Sewage and reclaimed water treatment services				
- China	1,840	1,902	3.3%	
- Overseas	135	162	20.4%	Australia projects began its contribution
Water distribution services				
- China	736	827	12.4%	
- Overseas	104	188	81.4%	Australia projects began its contribution
Construction of BOT water projects				
- China	2,802	3,289	17.4%	4.8mtpd were under construction
Construction services for comprehensive renovation projects	2,889	2,463	-14.7%	Due to the decrease in contribution work for Inner Mongolia
Technical services and sales of machineries	622	1,179	89.5%	Contribution from provision of technical services increased
Total	9,126	10,009	9.7%	
Turnover by segment, % of total				
Sewage and reclaimed water treatment services				
- China	20.2%	19.0%	-1.2ppts	
- Overseas	1.5%	1.6%	+0.1ppts	
Water distribution services				
- China	8.1%	8.3%	+0.2ppts	
- Overseas	1.1%	1.9%	+0.8ppts	
Construction of BOT water projects				
- China	30.7%	32.9%	+2.2ppts	
Construction services for comprehensive renovation projects	31.7%	24.6%	-7.1ppts	
Technical services and sales of machineries	6.8%	11.8%	+5.0ppts	
Total	100.0%	100.0%		
Gross profit (HK\$ mn)				
Sewage and reclaimed water treatment services				
- China	1,093	1,103	0.9%	
- Overseas	38	45	19.2%	
Water distribution services				
- China	385	413	7.4%	
- Overseas	31	56	79.0%	
Construction of BOT water projects				
- China	672	822	22.3%	
Construction services for comprehensive renovation projects	433	648	49.5%	
Technical services and sales of machineries	404	747	84.9%	
Total	3,057	3,834	25.4%	
Gross margin ratio (%)				
Sewage and reclaimed water treatment services				
- China	59%	58%	-1.0ppts	Issuance of ABN with a principal amount of RMB2.1bn in 2017 led to reductions in imputed interest income
- Overseas	28%	28%	0.0ppts	
Water distribution services				
- China	52%	50%	-2.0ppts	Newly acquired projects had a lower margin
- Overseas	30%	30%	+0.0ppts	
Construction of BOT water projects				
- China	24%	25%	+1.0ppts	
Construction services for comprehensive renovation projects	15%	26%	+11.0ppts	1) Projects for the period had a higher margin; and 2) reduction in construction cost due to direct involvement in procurement of equipment and construction materials for certain projects
Technical services and sales of machineries	65%	63%	-2.0ppts	
Overall	33%	38%	+5.0ppts	

Sources: Company data, CMS (HK)

Maintain BUY and DCF-based TP at HK\$6.1

Shares are trading at 2019E PEG of 0.5x vs sector average of 0.9x, valuation looks undemanding. BEW's rich cash position allows it to consolidate market amid the tightening credit environment. The potential M&As provide upside potential to our earnings forecast and valuation. We reiterate BUY and TP at HK\$6.1.

Key risks

The key upside risks to our forecast are: 1) the company obtaining more PPP projects than management guided; 2) stricter pollutant control on wastewater discharges resulting in the acceleration of WWT plant upgrades and tariff hike; and 3) higher return from new projects (esp. PPP projects).

The key downside risks to our target price include: 1) keener-than-expected market competition resulting in slower capacity expansion and lower project return; 2) slower progress in its investment fund; 3) higher-than-expected execution risk for its PPP projects; and 4) unable to pass through the increased costs to end-users in its water distribution service business.

Financial Summary

Balance Sheet

Year ended 31 Dec (HK\$m)	2016	2017	2018E	2019E	2020E
Fixed assets	2,831	3,842	4,282	4,718	5,150
Associates & JV	5,685	10,653	11,715	12,970	14,413
Operating concessions	3,390	4,191	4,379	4,453	4,418
Receivables under services concession arrangement	22,638	33,323	39,749	44,956	49,349
Amounts due from contract customers	16,204	15,060	18,861	22,639	26,667
Trade receivables, prepayment and other receivables	3,394	3,847	4,346	4,781	5,218
Others	4,930	6,007	6,053	6,106	6,169
Non-current assets	59,072	76,922	89,385	100,623	111,383
Amounts due from contract customers	1,101	876	1,097	1,316	1,551
Receivables under services concession arrangement	1,933	2,615	3,119	3,528	3,872
Trade receivables, prepayment and other receivables	7,439	9,598	10,946	12,053	13,128
Cash	10,921	9,939	8,954	6,502	5,246
Restricted cash and pledged deposits	135	46	46	46	46
Others	446	465	486	506	524
Current assets	21,975	23,539	24,648	23,951	24,367
Total assets	81,047	100,461	114,034	124,574	135,750
Trade payables	9,843	11,688	13,500	15,201	16,757
Accruals & other payables	5,234	6,770	7,845	8,833	9,737
Bank loans	4,812	4,689	5,317	5,945	6,573
Corporate bonds, note payable and others	52	3,853	308	753	2,378
Others	673	694	734	870	961
Current liabilities	20,615	27,693	27,703	31,602	36,407
Bank loans	16,663	21,444	24,316	27,188	30,059
Corporate bonds, note payable and others	14,644	13,966	17,370	16,824	15,126
Others	2,359	4,317	4,511	4,856	5,487
Non-current liabilities	33,665	39,726	46,197	48,867	50,672
Total liabilities	54,280	67,420	73,900	80,469	87,079
Total net assets	26,767	33,041	40,134	44,105	48,671
Share capital	874	879	944	948	948
Reserves	15,627	19,905	22,576	25,698	29,324
Shareholder's equity	16,501	20,785	23,521	26,646	30,272
Perpetual capital instruments	6,305	6,623	10,454	10,695	10,936
Minority interests	3,961	5,634	6,159	6,764	7,463
Total Equity	26,767	33,041	40,134	44,105	48,671
Total debts	36,171	43,952	47,311	50,710	54,137
Net cash/(debts)	(25,115)	(33,967)	(38,311)	(44,162)	(48,844)
BVPS (HK\$)	1.89	2.37	2.51	2.82	3.19

Cashflow Statement

Year ended 31 Dec (HK\$m)	2016	2017	2018E	2019E	2020E
Operating profit	4,947	5,279	6,272	7,287	8,370
Dep. & Amort.	302	405	489	543	595
Chg in working cap	(7,879)	(12,279)	(9,962)	(8,538)	(8,145)
Others	459	421	(338)	(91)	121
Tax paid	(329)	(541)	(669)	(818)	(1,003)
Net cash from operations	(2,500)	(6,714)	(4,208)	(1,618)	(62)
Capex	(1,063)	(1,208)	(1,110)	(1,045)	(982)
Others	(966)	1,093	415	448	463
Net cash from investments	(2,029)	(115)	(695)	(597)	(518)
Issue/ buyback of shares	(82)	0	3,655	0	0
Dividends paid	(958)	(1,227)	(1,571)	(1,836)	(2,132)
Net change in debt	5,871	6,275	3,500	3,500	3,500
Others	4,638	(1,079)	(1,666)	(1,902)	(2,043)
Net cash from financing	9,469	3,968	3,918	(238)	(675)
Net change in cash	4,940	(2,861)	(985)	(2,452)	(1,255)
Adjustments	(384)	1,887	1,343	1,343	1,343
Opening cash	6,366	10,912	8,596	7,611	5,159
Closing cash	10,921	9,939	8,954	6,502	5,246

Profit & Loss Statement

Year ended 31 Dec (HK\$m)	2016	2017	2018E	2019E	2020E
Turnover	17,355	21,192	24,504	27,681	30,792
COGS	(11,570)	(14,728)	(17,012)	(19,155)	(21,116)
Gross profit	5,785	6,465	7,493	8,526	9,676
Other income and gains, net	1,011	911	1,145	1,349	1,557
Admin	(1,538)	(1,753)	(1,996)	(2,202)	(2,466)
Other opex	(311)	(343)	(370)	(386)	(397)
Total opex	(838)	(1,186)	(1,221)	(1,239)	(1,306)
Operating profit	4,947	5,279	6,272	7,287	8,370
Finance costs, net	(1,198)	(1,177)	(1,396)	(1,637)	(1,797)
Share of results of associates	182	557	691	816	939
Others	713	657	647	765	880
Pre-tax profit	4,644	5,315	6,214	7,231	8,391
Tax	(971)	(875)	(1,048)	(1,243)	(1,479)
Profit after tax	3,673	4,441	5,166	5,988	6,912
Minority Interest	(389)	(483)	(550)	(633)	(732)
Holdings of perpetual capital instruments	(57)	(240)	(241)	(241)	(241)
Net profit	3,227	3,717	4,375	5,114	5,939
Non-core items adj.	(520)	(135)	0	0	0
Core profit	2,707	3,582	4,375	5,114	5,939
EBITDA	5,249	5,684	6,761	7,830	8,965
Basic EPS (HK\$)	0.37	0.42	0.47	0.54	0.63
Fully diluted core EPS (HK\$)	0.30	0.40	0.46	0.53	0.62
DPS (HK\$)	0.12	0.16	0.18	0.21	0.24

Financial Ratios

	2016	2017	2018E	2019E	2020E
YoY growth rate (%)					
Turnover	28.5	22.1	15.6	13.0	11.2
EBITDA	26.3	8.3	18.9	15.8	14.5
Operating profit	25.3	6.7	18.8	16.2	14.9
Core profit	22.9	32.3	22.1	16.9	16.1
Fully diluted core EPS	23.4	31.6	14.9	16.3	16.1
DPS	25.3	30.3	16.4	16.5	15.7
Margins (%)					
Gross margin	33.3	30.5	30.6	30.8	31.4
EBITDA margin	30.2	26.8	27.6	28.3	29.1
EBIT margin	28.5	24.9	25.6	26.3	27.2
Net margin (Core profit)	15.6	16.9	17.9	18.5	19.3
Effective tax rate (%)	25.9	21.3	21.5	22.0	22.5
Total opex as % of rev	4.8	5.6	5.0	4.5	4.2
Interest coverage (x)	4.1	4.5	4.5	4.5	4.7
Dividend payout (%)	38.4	39.0	39.0	39.0	39.0
Net debt/equity (%)	93.8	102.8	95.5	100.1	100.4
Net debt/total cap (%)	48.4	50.7	48.8	50.0	50.1
Current ratio (x)	1.1	0.8	0.9	0.8	0.7
Returns (%)					
Asset turnover (x)	0.2	0.2	0.2	0.2	0.2
Financial leverage (x)	4.5	4.9	4.8	4.8	4.6
EBIT margin (%)	33.7	30.6	31.1	32.0	33.1
Interest burden (x)	0.8	0.8	0.8	0.8	0.8
Tax burden (x)	0.7	0.7	0.7	0.7	0.7
ROE (%)	19.7	19.9	19.7	20.4	20.9
ROIC (%)	9.4	9.0	8.6	8.7	9.4

Sources: Company data, CMS (HK) estimates

Investment Ratings

Industry Rating	Definition
OVERWEIGHT	Expect sector to outperform the market over the next 12 months
NEUTRAL	Expect sector to perform in-line with the market over the next 12 months
UNDERWEIGHT	Expect sector to underperform the market over the next 12 months

Company Rating	Definition
BUY	Expect stock to generate 10%+ return over the next 12 months
NEUTRAL	Expect stock to generate +10% to -10% over the next 12 months
SELL	Expect stock to generate loss of 10%+ over the next 12 months

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