

China Water Affairs Group

Improvements at Kangda International

FY19 results from Kangda International Environmental (KIE) showed an improvement in profitability and China Water Affairs (CWA) has put in place a deal to increase its holding in its associate company. While the precise financial impact of the COVID-19 pandemic has yet to be clarified, we have left our FY20 forecasts unchanged, but CWA's current rating appears modest for such a defensive company.

Year end	Revenue (HK\$m)	PBT* (HK\$m)	EPS* (c)	DPS (c)	P/E (x)	Yield (%)
03/18	7,580	2,462	71.8	23.0	8.6	3.7
03/19	8,302	2,772	85.1	28.0	7.2	4.6
03/20e	8,757	3,169	98.2	33.0	6.3	5.4
03/21e	9,894	3,417	106.1	38.0	5.8	6.2

Note: *PBT and EPS are normalised, excluding amortisation of acquired intangibles, exceptional items and share-based payments.

CWA increases holding in Kangda International

KIE (CWA holds c 29.5%) recently released its results for the year ending December 2019. The headline numbers showed good progress, with PBT +12% and EPS +25%, which will feed into CWA's FY20 results. CWA subsequently announced that it had entered into an agreement to subscribe to an issue of exchangeable bonds in KIE (HK\$361.3m and convertible into 344.13m KIE shares). In a related transaction, an issue of convertible bonds (into CWA shares) allowed CWA to fund the purchase of the exchangeable bonds in KIE. Assuming full conversion (after July 2022), CWA will hold 46.5% of KIE. In our view, the deal represents an attractive opportunity for CWA to consolidate its position as KIE's largest shareholder. The effective price of HK\$1.05/share stands at a 56.6% discount to KIE's book value of HK\$2.42 and represents c 5.2x FY19 EPS.

COVID-19

We have not attempted to estimate the financial effect of the spread of COVID-19 in our (unchanged) FY20 and (modestly revised) FY21 forecasts. We anticipate that there will have been delays to some capital projects because of the COVID-19-related extension of the New Year holiday in China. We would expect to see some reduction in industrial and commercial water volumes, although higher domestic and municipal volumes may compensate for this shortfall. Our model assumes c 15% growth in water supply revenue in FY20 (+13.4% in H120 vs H119) and FY21. A theoretical increase of only 8% in water revenues in FY21 would lead to a c 5% reduction in our operating profit estimate, from HK\$3,785m to HK\$3,610m.

Valuation: Rating remains modest despite rebound

At the current price of c HK\$6.15/share, CWA is trading on a modest 6.3x our FY20e EPS of 98.2c and 5.8x our FY21e EPS of 106.1c (peer group averages are 13.3x and 13.5x respectively). Although uncertainty persists as to the financial impact of COVID-19, CWA remains a defensive play in a sector where we see a secular trend of improvement in the quality of water providing continuing growth opportunities for CWA.

Additional investment

Utilities

28 April 2020

Price **HK\$6.15**

Market cap **HK\$9,865m**

Net debt (HK\$bn) at 30 September 2019 11.0

Shares in issue 1,604m

Free float 66%

Code 855

Primary exchange HK

Secondary exchange N/A

Share price performance



% 1m 3m 12m

Abs 6.1 (7.7) (26.3)

Rel (local) 2.6 6.3 (10.1)

52-week high/low HK\$8.18 HK\$5.29

Business description

China Water Affairs (CWA) is a pioneer in the privatisation of water supply assets in China. The company seeks to create growth via volume/price increases

Next events

FY20 results June 2020

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Focus on Kangda International Environmental

CWA's initial investment in KIE

In April 2019, CWA acquired 29.52% of Kangda International Environmental (HKSE: 06136) from Kangda Holdings for HK\$1.2bn (600m shares at a price of HK\$2/share), implicitly valuing the entire business at HK\$4.1bn. Post the acquisition, CWA became the largest single shareholder in KIE, taking control of KIE's board. CWA treats its holding in KIE as an equity investment.

KIE's business encompasses urban water treatment, water remediation and rural water improvements. Urban water treatment includes design construction and operation of waste treatment plants, among other activities, while water environment remediation is focused on harnessing and improving rivers, pipeline network projects and pipe tunnel construction. Rural water improvement involves construction and operation in the areas of pipeline and waste water treatment, designed to aid the construction of 'beautiful villages'. In the future, CWA will focus the business on the urban water treatment segment.

KIE's results show progress

On 27 March 2020, KIE released its FY19 results, the first set of annual figures since CWA acquired its holding. The headline numbers showed revenue -7%, PBT +12% and EPS +25%.

For the major part, the decline in revenue resulted from a decrease in construction revenues (RMB341.3m), particularly in the urban water treatment division, which more than offsets the increase in operational revenue (RMB74.3m) generated by the commencement of new build-operate-transfer (BOT) upgrade projects. However, gross profit rose by 12% to RMB1,163m, thanks to a higher margin on completed engineering, procurement and construction (EPC) projects. Stringent control of selling and distribution expenses (-65%), and administrative (-14%) and other costs (-40%) also helped produce an overall increase in PBT to RMB509.8m, despite an increase (+12%) in financing costs, to RMB557.5m, due to higher levels of indebtedness and a higher rate of interest in H219. A lower tax rate of 25% (32%) contributed to the increase in EPS to RMB18.54c (+25%). Overall, the gearing ratio (net debt divided by capital and net debt) of the business remained static at 70%. Reducing KIE's level of gearing will constitute an important part of CWA's strategy for improving the performance of KIE over the next two years.

CWA increases its holding in KIE

Subsequent to KIE's results (on 1 April 2020), CWA announced that it had entered into an agreement to subscribe to an issue, by Baring Private Equity Asia (BPEA), of exchangeable bonds in respect of its share in KIE. In turn, the issue of convertible bonds (into CWA shares) to BPEA allowed CWA to fund the acquisition of the exchangeable bonds in KIE from BPEA.

For its part, CWA agreed to subscribe to the exchangeable bonds issued by BPEA, amounting to HK\$361.3m, entitling it to convert the bonds (not before August 2022) into 344.13m KIE shares (equivalent to 16.93% of KIE's capital) at an effective price of HK\$1.05/share. The price represents a premium of 38.2% over the closing price for KIE's shares on 1 April, but a significant discount (56.6%) to KIE's net assets of HK\$2.42/share (at 31 December 2019). The price is substantially below the acquisition cost of the first tranche of shares (HK\$2/share) and reduces CWA's overall 'in' cost to c HK\$1.65/share. The HK\$1.05 price also represents c 5.2x KIE's FY19 EPS of RMB0.1854 equivalent to HK\$0.230. Sharp Profit, a wholly owned subsidiary of CWA, which currently holds CWA's 29.52% stake in KIE, will hold the bonds and, assuming full conversion of the bonds and no issuance of further capital by KIE, will eventually hold 46.45% of KIE.

The issue of a convertible bond to BPEA has provided the consideration of HK\$361m. On conversion (after July 2022), the bond will convert into 44.9m CWA shares (equivalent to approximately 2.80% of the existing issued share capital of the company). The conversion price of HK\$8.05 represents a premium of c 42% to the share price prevailing immediately before the announcement of the deal and a significant premium (c 63%) to CWA's FY19 NAV of HK\$4.95/share. HK\$8.05 is also equivalent to c 9.5x CWA's FY19 EPS of 85.1c and c 8.2x FY20e EPS of 98.2c.

Deal rationale

The directors of CWA are optimistic about the prospects for KIE and point to an improving financial performance in FY19, helped by a significant reduction in costs and an optimised tax rate, which we have detailed above. CWA considers the subscription an opportunity to increase its holding in KIE and consolidate its position as KIE's largest shareholder without any adverse impact on cash flow. The deal has been struck on attractive terms, which should allow CWA to capture a greater share of the improvement expected in KIE's business over the next two years without having to consolidate KIE's significant debt on the balance sheet.

COVID-19 update

CWA will report its results for the 12 months ending 31 March towards the end of June. The results will include the first quarter of 2020, which coincided with the peak of COVID-19 in China. CWA has not publicly quantified the impact of the epidemic on its business and we have not altered our forecasts to attempt to estimate the financial effect of the spread of the disease. However, we believe it is worth noting some of the potential effects of the virus. We expect there will have been delays to some capital projects, for example plant construction, as a result of the extension of the New Year holiday in China in an attempt to contain the spread of the coronavirus. We would also expect some reduction in industrial and commercial water volumes, although higher domestic and municipal volumes may compensate for this shortfall. Our model assumes c 15% growth in water supply revenue in FY20 (H120: 13.4%) and FY21. An 8% increase in water revenues in FY21 would lead to a c 5% reduction in our operating profit estimate, from HK\$3,785m to HK\$3,610m. However, CWA may have also been able to take advantage of some of the government's schemes (reduction in VAT, cheap loans, reduced electricity prices) introduced to combat the economic impact of the virus. We remain confident that the long-term growth opportunity remains.

Forecasts and valuation

Our forecasts for FY20 remain unchanged and we have made only a small revision to our FY21 estimates (EPS +0.5% from 105.6c to 106.1c). At the current price of c HK\$6.15/share, CWA is trading on a modest 6.3x our FY20e EPS of 98.2c and 5.8x our FY21e EPS of 106.1c (averages for selected Hong Kong- and China-listed peers are 13.3x and 13.5x respectively). Although considerable uncertainty persists as to the extent of the financial impact of COVID-19, CWA remains a relatively defensive play in a sector where we expect the secular trend towards improvements in the quality and availability of water in China to provide continuing growth opportunities.

Exhibit 1: Financial summary

	HK\$m	2017	2018	2019	2020e	2021e
31-March		HKFRS	HKFRS	HKFRS	HKFRS	HKFRS
PROFIT & LOSS						
Water supply revenue		4,874	6,204	6,376	7,268	8,330
Environmental Protection		531	814	1522	1065	1119
Other segments		303	562	404	424	445
Revenue TOTAL		5,708	7,580	8,302	8,757	9,894
EBITDA		2,646	3,097	3,507	3,899	4,473
Operating Profit		2,271	2,691	3,022	3,289	3,785
Amortization		315	334	404	480	528
Depreciation		60	71	81	130	160
Net Interest expense		(251)	(289)	(319)	(493)	(555)
Profit Before Tax		1,963	2,462	2,772	3,169	3,417
Tax		(583)	(701)	(642)	(729)	(786)
Profit After Tax		1,379	1,762	2,130	2,440	2,631
Net profits contributable to shareholders		853	1,141	1,369	1,586	1,710
Average Number of Shares Outstanding (m)		1,505	1,571	1,609	1,606	1,604
EPS - fully diluted (c)		55.4	71.8	85.1	98.2	106.1
Dividend per share (c)		20.0	23.0	28.0	33.0	38.0
EBITDA Margin (%)		46.4	40.9	42.2	44.5	45.2
Operating Margin (%)		39.8	35.5	36.4	37.6	38.3
BALANCE SHEET						
Fixed Assets		15,689	19,581	24,493	28,666	31,922
Intangible Assets		10,316	13,499	16,514	19,534	22,506
Plant, property and equipment		1,127	1,695	2,020	1,990	1,930
Investment properties		1,173	909	912	915	918
Investment in associates		635	661	676	1,483	1,637
Other		2,438	2,817	4,371	4,744	4,931
Current Assets		9,942	9,008	11,332	11,911	9,911
Properties Under Development		690	1,370	1,274	1,274	1,274
Properties Held for Sale		289	597	816	816	816
Inventory		285	348	531	560	633
Trade and Bills Receivables		872	1,055	1,243	1,311	1,481
Due from Non-controlling Equity Holders of Subsidiaries		251	260	288	323	349
Due from Associates		409	563	227	227	227
Prepayments, Deposits and Other Receivables		1,743	1,293	1,550	1,635	1,847
Pledged Deposits		783	570	645	645	645
Deposits and cash		4,314	2,511	3,973	4,335	1,855
Other		307	440	785	784	784
Current Liabilities		7,393	8,649	10,019	11,616	9,991
Trade and Bills Payables		1,097	1,626	2,410	1,400	1,500
Accrued Liabilities, Deposits and Other Payables		2,102	2,306	1,979	2,529	2,822
Short-term Borrowings		3,206	3,450	3,437	5,295	3,144
Other		988	1,267	2,192	2,392	2,525
Long Term Liabilities		9,275	8,786	12,903	14,026	15,107
Long-term Borrowings		8,123	7,432	11,494	12,494	13,494
Other long term liabilities		1,152	1,354	1,409	1,532	1,613
Shareholders' Equity		8,963	11,154	12,902	14,934	16,735
CASH FLOW						
Net Cash Flows from Operating Activities		1,452	1,632	1,429	2,554	3,299
Purchase of property, plant and equipment		(92)	(100)	(100)	(100)	(100)
Increase in concession rights for water supply and sewage processing		(1,808)	(2,500)	(2,500)	(3,500)	(3,500)
Acquisitions/disposals		(283)	0	0	(1,200)	(361)
Increase in prepayments and other receivables		(1,226)	0	0	0	0
Others		(134)	(171)	(708)	159	164
Net Cash Flows from Investing Activities		(3,543)	(2,771)	(3,308)	(4,641)	(3,797)
Dividends		(135)	(369)	(450)	(530)	(610)
Shares issue and/or options exercised		(38)	301	0	(34)	0
Other		245	(362)	(183)	(205)	(221)
Net Cash Flow		(2,020)	(1,569)	(2,513)	(2,857)	(1,329)
Opening net debt (CWA definition)		4,213	6,232	7,801	10,313	13,170
Closing net debt/(cash)		6,232	7,801	10,313	13,170	14,499
Net debt to equity ratio (CWA definition)		70%	70%	80%	88%	87%

Source: Company accounts, Edison Investment Research

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