

# China Water Affairs Group

Site visit

## Site trip confirms opportunity

Edison visited three water sites belonging to China Water Affairs Group (CWA) in the heavily industrialised Guangdong province in mainland China. The sites encompassed a raw water/reservoir facility, an industrial waste water treatment plant and a water supply business. A three-hour drive from Hong Kong, the sites visited depend heavily on the Huizhou Industrial Zone, which has been developed by the Chinese government and various private companies since its inception in the early 1990s. The visit assured us of the robust, high-quality nature of CWA's assets and underscored how fundamental raw water provision and waste water treatment are to the Chinese industrial strategy. Ultimately, this gives us enhanced confidence in our high, long-term growth forecasts for CWA.

Year end	Revenue (HK\$m)	PBT* (HK\$m)	EPS* (c)	DPS (c)	P/E (x)	Yield (%)
03/15	2,859	886	16.6	7.0	31.1	1.4
03/16	4,033	1,337	38.5	8.0	13.4	1.6
03/17e	6,255	2,031	55.5	10.0	9.3	1.9
03/18e	7,535	2,168	58.8	12.5	8.8	2.4

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

## Site visit: Scale of opportunity apparent

While the assets we visited in Huizhou were exposed to industrial water supply and treatment – the vast majority of CWA's activities are in urban water supply – we were reassured to see how integral water management is to state-directed Chinese industrial expansion and to see for ourselves how much room for growth there is for private Chinese water companies. We also appreciated meeting and conversing with local management teams at each asset and gained a sense of how professionally each of the businesses is run. For investors accustomed to water utilities listed in the US and Europe, the notion of a water utility returning double-digit profit growth can be hard to fathom. Our visit to Huizhou gave us several examples of the planned capacity increases necessary to facilitate such a high level of industrial expansion (in the case of Huizhou, oil refining and ethylene capacity were forecast to double between 2014 and 2016). It is common for CWA's subsidiaries in Huizhou to have to provide year-on-year volume increases for customers well into double-digit percentages across its raw water, waste water treatment and tap water supply businesses.

## Earnings and valuation: Unchanged at top of market

We have left our earnings forecasts and valuation unchanged as we view FY17 results, expected in June, as a more appropriate time to revisit numbers. It is noteworthy that we are on average 14.4% ahead of Bloomberg consensus EBITDA estimates (2017 to 2019) and 3.8% ahead of Bloomberg EPS consensus (also 2017-2019). Our five-year reported EBITDA CAGR is 20.5% and our fair value per share of HK\$7.12 offers equity holders 37.5% upside to the share price of HK\$5.18 at the time of publication.

### Utilities

4 May 2017

**Price** **HK\$5.16**
**Market cap** **HK\$7,839m**

HK\$7.78/US\$

Net debt (HK\$m) at 30 September 2016 6,016

Shares in issue 1,519.1m

Free float 46.8%

Code 855

Primary exchange HK

Secondary exchange N/A

### Share price performance



% 1m 3m 12m

Abs (0.6) (0.6) 33.7

Rel (local) (2.3) (6.7) 14.6

52-week high/low HK\$6.0 HK\$3.9

### Business description

China Water Affairs Group owns and operates regulated water supply assets across 40 cities in mainland China, serving eight million customers in the residential, commercial and industrial sectors.

### Next event

FY17 results June 2017

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## Notes from a visit: Water integral to industrial strategy

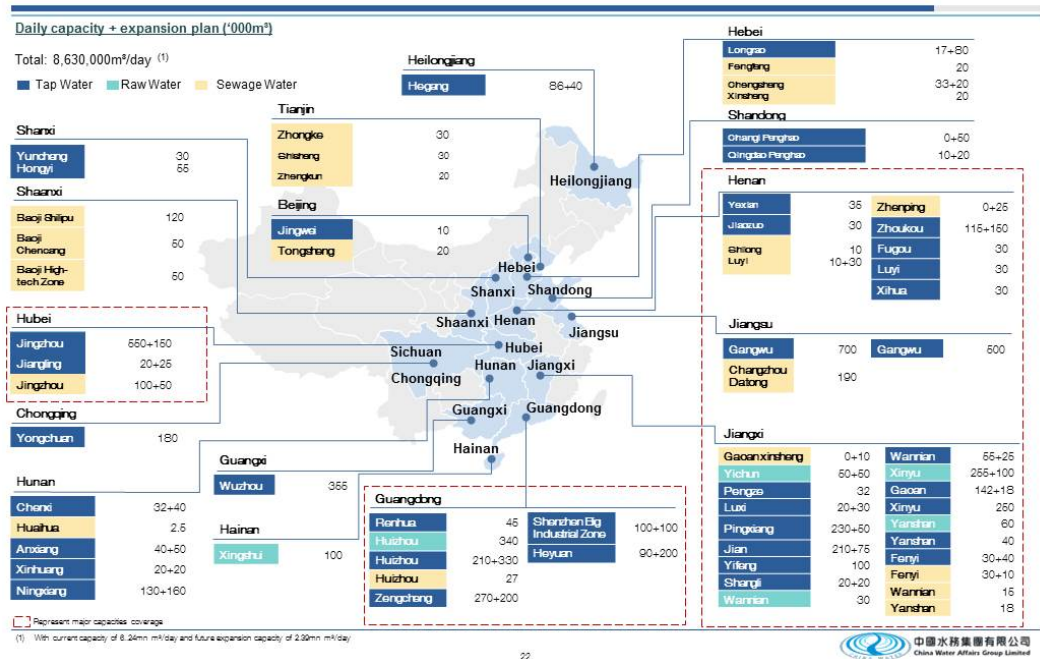
In April, we visited three of CWA's waster operations in the Huizhou Industrial Zone, Guangdong, China. CWA's assets are integral to the Petrochemical Zone, located in the Huizhou Daya Bay Economic and Technological Development Zone. Since its inception in the early 1990s, the Petrochemical Zone has expanded significantly. According to the website, as of 2014, more than 20 companies including several international players have built 75 projects involved in a range of activities from oil refining to ethylene production. In 2014, the refining capacity of the Development Zone was 12 million tonnes per year and the ethylene production capacity was 950,000 tonnes per year. These figures were expected to grow to 22 million tonnes per year and 2 million tonnes per year by 2016.

Underlying the expansion of the Development Zone, there has been significant development in supporting infrastructure. On top of the 'three-dimensional marine, land and air' transportation network comprising eight expressways, four airports, railways lines and a port, water supply is central to petrochemical development given the water-intense nature of refining and other oil processing activities. As the largest of the four water sources in the Development Zone, Fengtian Reservoir has an important role to play in the future economic development of the region.

As Exhibit 1 shows, Huizhou is simply the main part of CWA's activities in Guangdong. Guangdong itself only accounts for 17.4% (1.082mm<sup>3</sup>/day out of 6.23mm<sup>3</sup>/day) of CWA's total capacity. CWA's existing capacity across the whole of China of 6.23mm<sup>3</sup>/day is expected to grow to 8.69mm<sup>3</sup>/day in the coming years and our model has this capacity increasing further. In other words, our site visit showed the high levels of growth available to CWA and its subsidiaries but in only one proportionally small part of CWA's activities. When coupled with the available growth in urban water supply and different regions, we began to get a sense of the scale of the opportunity for CWA.

**Exhibit 1: Location of CWA's Guangdong water assets**

### Extensive and Exclusive Water Supply Coverage in Over 40 Cities in China



## Fengtian Reservoir, Huizhou: Raw water

Fengtian reservoir has a total capacity of 25.43 cubic metres. It supplies industrial customers in the Development Zone in Daya Bay, Huizhou. It has a capacity ceiling of 1mm<sup>3</sup>/day, which is well below the current supply rate.

**Exhibit 2: Reservoir**



Source: Edison Investment Research

**Exhibit 3: Reservoir with view of the dam**



Source: Edison Investment Research

## Huizhou Daya Bay Water Affairs

With a total supply capacity of 340,000 cubic meters, the Huizhou Daya Bay Water Supply Business is a monopoly supplier of water to a range of industrial clients in the Huizhou Industrial Zone. Industrial companies that rely on the Huizhou Daya Bay Water Supply Business include those active in tyre manufacturing, oil and gas, automotive, chemicals and electrical equipment. CWA bought a majority stake in the company in 2008.

**Exhibit 4: Main office building**



Source: Edison Investment Research

**Exhibit 5: Water purification**



Source: Edison Investment Research

The water treatment facilities in Daya Bay employ a variety of technologies and have excess capacity for use as the Huizhou Industrial Zone expands in the coming years. Current usage is 210,000m<sup>3</sup>/day and the client, the China National Offshore Oil Corporation (CNOOC), will require an extra 70,000m<sup>3</sup>/day by the end of the year with growth anticipated thereafter so that the plant will reach its full near-term capacity of 330,000m<sup>3</sup>/day before 2020.

Exhibits 4-7 show various parts of the water treatment plant including the main office, the main treatment ponds, the pump room and the control station. The technologies used are robust and well established. There are few examples of advanced water treatment technologies such as ultraviolet treatment and reverse osmosis in China currently.

**Exhibit 6: Control station in the plant**



Source: Edison Investment Research

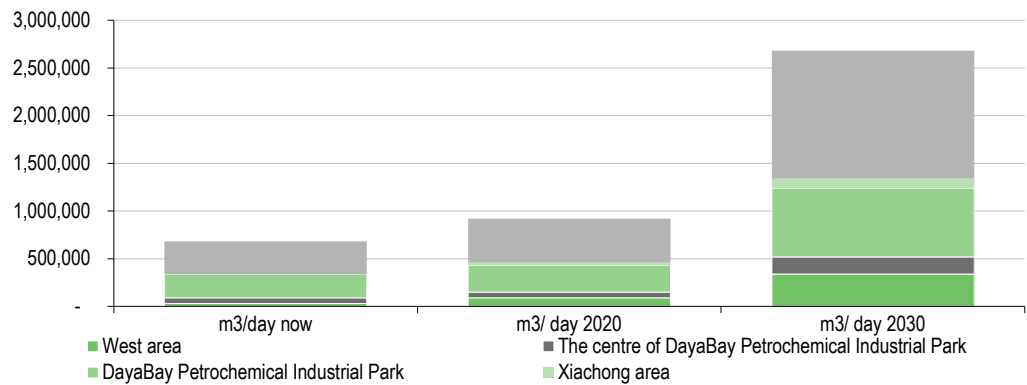
**Exhibit 7: Pump room**



Source: Edison Investment Research

Exhibit 8 shows CWA has significant plans for water supply growth in Daya Bay over the long term.

**Exhibit 8: Growth potential of Huizhou Daya Bay Water Supply Business**



Source: CWA

### Yiyuan water plant: Petrochemical wastewater treatment

Acquired by CWA in 2009, the Yiyuan Purified Water Company treats contaminated waste water from the nearby Petrochemical Development Zone. It is the activity that CWA has in Huizhou that is not protected by monopoly status, as Shell and CNOOC treat their own waste water. However, all other companies active in the Petrochemical Zone use this facility.

Exhibits 9 and 10 below show how polluted the waste water received by Yiyuan is and how effective the various processes used by the company are at purifying the water. At the time of the acquisition, CWA stated that the company had capacity to treat 80,000m3/day.



**Exhibit 9: Site manager shows water treatment by stage**


Source: Edison Investment Research

**Exhibit 10: Main petrochemical waste water treatment facility**


Source: Edison Investment Research

## Financials and valuation

**Exhibit 11: Edison earnings versus consensus**

Edison versus consensus	HKD (m)	2017e	2018e	2019e
<b>Edison revenues (HK\$m)</b>		<b>6,255</b>	<b>7,535</b>	<b>9,114</b>
Bloomberg revenues		5,979	6,715	7,882
+/- Edison vs consensus		4.6%	12.2%	15.6%
<b>Edison EBITDA (HK\$m)</b>		<b>2,659</b>	<b>2,805</b>	<b>3,435</b>
Bloomberg EBITDA		2,277	2,539	2,963
+/- Edison vs consensus		16.8%	10.5%	15.9%
<b>Edison EBIT (HK\$m)</b>		<b>2,218</b>	<b>2,338</b>	<b>2,899</b>
Bloomberg EBIT		1,999	2,331	2,938
+/- Edison vs consensus		11.0%	0.3%	-1.3%
<b>Edison EPS (HK\$c)</b>		<b>55.0</b>	<b>58.4</b>	<b>72.7</b>
Bloomberg EPS		51.8	57.7	69.8
+/- Edison vs consensus		6.3%	1.1%	4.1%
<b>Edison DPS (HK\$c)</b>		<b>10.0</b>	<b>12.5</b>	<b>15.0</b>
Bloomberg DPS		10.6	12.4	14.3
+/- Edison vs consensus		-5.7%	0.8%	4.9%
<b>Edison capex (HK\$m)</b>		<b>(1,082)</b>	<b>(2,129)</b>	<b>(2,532)</b>
Bloomberg capex		(961)	(1,309)	(1,766)
+/- Edison vs consensus		12.7%	62.7%	43.4%
<b>Edison net debt (HK\$m)</b>		<b>4,874</b>	<b>5,714</b>	<b>6,802</b>
Bloomberg net debt		5,526	5,516	6,022
+/- Edison vs consensus		-11.8%	3.6%	13.0%

Source: Bloomberg data taken on 28 April 2017

We have left our earnings forecasts unchanged for CWA. We are comfortable being well ahead of consensus at both EBITDA and EPS between 2017 and 2019 by an average of 14.4% and 3.8% respectively. Our site visit to China has helped us better understand the scale of opportunity that CWA enjoys; however, we already have significant growth in our earnings forecasts. We expect

CWA to report FY17 results in June, at which point we will revisit our numbers. We also leave our fair value per share of HK\$7.12 unchanged, which offers equity holders 37.5% upside to the share price of HK\$5.18 at the time of publication.

**Exhibit 12: Financial summary**

	HK\$m	2014	2015	2016	2017e	2018e	2019e	2020e
Year end 31 March		IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
<b>PROFIT &amp; LOSS</b>								
Revenue		2,747	2,859	4,033	6,255	7,535	9,114	10,542
EBITDA		1,075.8	1,299.8	1,820.2	2,649.5	2,796.1	3,425.4	3,972.7
Operating Profit (before amort. and except.)		771	1,001	1,479	2,218	2,338	2,899	3,365
Intangible Amortisation		0	0	0	0	0	0	0
Exceptionals		58	136	(30)	0	0	0	0
Other		0	0	0	0	0	0	0
Operating Profit		829	1,137	1,449.1	2,218.1	2,337.7	2,899	3,365
Net Interest		(107)	(117)	(171)	(162)	(185)	(214)	(252)
Profit Before Tax (norm)		729.7	885.6	1,337.4	2,031.0	2,167.6	2,699.8	3,127.8
Profit Before Tax (FRS 3)		788	1,021	1,308	2,031	2,168	2,700	3,128
Tax		(230)	(317)	(305)	(508)	(542)	(675)	(782)
Profit After Tax (norm)		500	569	1,033	1,523	1,626	2,025	2,346
Profit After Tax (FRS 3)		558	704	1,003	1,523	1,626	2,025	2,346
Average Number of Shares Outstanding (m)		1,423.2	1,416.9	1,508.5	1,509.4	1,519.9	1,519.9	1,519.9
EPS - normalised (c)		15.7	16.6	38.5	55.5	58.8	73.3	84.9
EPS - normalised and fully diluted (c)		15.69	16.59	38.54	55.50	58.83	73.27	84.89
EPS - (IFRS) (c)		19.8	26.2	36.6	55.5	58.8	73.3	84.9
Dividend per share (c)		5.0	7.0	8.0	10.0	12.5	15.0	17.5
EBITDA Margin (%)		39.2	45.5	45.1	42.4	37.1	37.6	37.7
Operating Margin (before GW and except.) (%)		28.1	35.0	36.7	35.5	31.0	31.8	31.9
<b>BALANCE SHEET</b>								
Fixed Assets		8,578	9,416	11,313	11,989	13,645	15,635	16,688
Intangible Assets		424	415	1,428	1,428	1,428	1,428	1,428
Tangible Assets		5,425	5,995	6,716	7,367	9,038	11,043	12,111
Investments		1,827	2,106	2,242	2,267	2,252	2,237	2,222
Other		902	901	928	928	928	928	928
Current Assets		4,929	5,686	7,507	9,337	10,440	11,469	12,445
Stocks		249	301	289	448	539	652	754
Debtors		578	656	1,084	1,681	2,025	2,449	2,832
Cash		1,590	1,501	2,552	3,092	3,451	3,563	3,710
Other		2,513	3,228	3,583	4,117	4,425	4,805	5,149
Current Liabilities		(3,972)	(5,214)	(5,557)	(5,668)	(5,973)	(6,228)	(6,464)
Creditors		(529)	(486)	(855)	(966)	(1,271)	(1,526)	(1,762)
Short term borrowings		(1,299)	(2,376)	(2,156)	(2,156)	(2,156)	(2,156)	(2,156)
Other		(2,143)	(2,352)	(2,546)	(2,546)	(2,546)	(2,546)	(2,546)
Long Term Liabilities		(3,839)	(3,452)	(5,715)	(6,915)	(8,115)	(9,315)	(9,315)
Long term borrowings		(3,524)	(3,024)	(5,076)	(6,276)	(7,476)	(8,676)	(8,676)
Other long term liabilities		(316)	(428)	(639)	(639)	(639)	(639)	(639)
Net Assets		5,696	6,436	7,548	8,743	9,998	11,562	13,354
<b>CASH FLOW</b>								
Operating Cash Flow		554	566	1,494	1,445	2,372	2,779	3,395
Net Interest		(34)	(0)	(72)	(162)	(185)	(214)	(252)
Tax		(106)	(201)	(160)	(508)	(542)	(675)	(782)
Capex		(794)	(781)	(670)	(1,082)	(2,129)	(2,532)	(1,676)
Acquisitions/disposals		0	0	(972)	0	0	0	0
Financing		(343)	(134)	(82)	0	0	0	0
Dividends		(71)	(85)	(106)	(136)	(167)	(205)	(258)
Net Cash Flow		(792)	(635)	(569)	(443)	(651)	(848)	427
Opening net debt/(cash)		2,234	3,377	3,966	4,649	5,092	5,743	6,590
HP finance leases initiated		0	0	0	0	0	0	0
Other		-351	46	-114	0	0	0	0
Closing net debt/(cash)		3,377	3,966	4,649	5,092	5,743	6,590	6,163

Source: CWA accounts, Edison Investment Research

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