

Singapore Company Focus

Hyflux Water Trust

Bloomberg: HYFT SP | Reuters: HYWT.SI

DBS Group Research . Equity

3 Jul 2008

BUY S\$0.64 STI : 2,906.23

Price Target : 12-Month S\$ 0.90

Reason for Report : Plant Visit Note

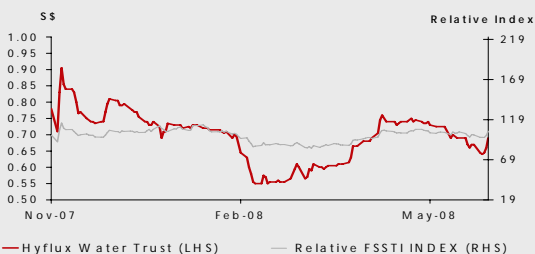
Potential Catalyst: Acquisition of Hyflux assets on offer

Analyst

Suvro Sarkar +65 6398 7973

suvro@dbsvickers.com

Price Relative



Forecasts and Valuation

FY Dec (\$\$ m)	2008F	2009F	2010F	2011F
Gross Revenue	52	38	40	43
Operating Profit	5	13	16	18
Net Profit	4	9	12	13
Distribution Inc	9	16	18	21
EPU (S cts)	1.4	3.0	3.9	4.3
EPU Gth (%)	N/A	114	28	11
DPU (S cts)	4.5	5.3	5.5	6.4
DPU Gth (%)	N/A	20	4	16
NAV per shr (S cts)	68.3	66.0	64.4	62.2
PE (X)	45.2	21.2	16.5	15.0
Distribution Yield (%)	7.0	8.3	8.7	10.0
P/NAV (x)	0.9	1.0	1.0	1.0
Net Debt to Equity (X)	CASH	CASH	CASH	CASH
ROAE (%)	2.0	4.4	5.8	6.7
Distn. Inc Chng (%) :	(6.5)	(3.1)	1.8	4.9
Consensus DPU (S cts) :	4.9	5.4	5.9	5.9

Sector : Industrials

Principal Business: First pure play global water business trust with an objective to invest in water-related infrastructure assets

More wind in the sails?

Story: We recently visited some of Hyflux Water Trust's ("HWT") water and wastewater assets in China, including one of the 9 plants offered by sponsor Hyflux to HWT for acquisition as part of the ROFOAR pipeline.

Point: We came back reassured about the Trust's ability to manage its assets and the inherent growth potential of its existing portfolio. HWT leverages on the experience and track record of parent Hyflux for all aspects of day-to-day operations and administration. Being located out of large industrial parks still in the early stages of development, HWT has a distinct advantage as it allows them to be a part of the industrial growth story being actively promoted by the local governments. Along with this potential of organic expansion, Hyflux has offered HWT a portfolio of 9 assets with a combined capacity of 290,000 cu m/day (representing about 65% of existing capacity) for potential acquisition, at an offer price of S\$180m. HWT currently has zero gearing and debt financing should not be a problem, with an US\$60m line already in place. Though the offer price looks to be on the higher side at first glance, at 1.6x P/BV (as against valuation of IPO portfolio at 1.3x P/BV), we believe that the acquisition should be yield-accretive from FY11 onwards. HWT would be taking its decision on the offer by 4Q08.

Relevance: We have revised our assumptions for water tariffs and utilisation rates for some of the plants in the existing portfolio based on information gathered off-the-ground. Hence, our DPU forecasts for FY08 and FY09 consequently stand reduced by 6% and 3% respectively. However, our DDM-backed target price remains unchanged at S\$0.90 and we continue to maintain BUY on the stock. Current dividend yield is attractive at 7.0% for FY08 and 8.3% for FY09. Expect a re-rating if and when HWT decides to acquire the Hyflux assets on offer.

At A Glance

Issued Capital (m shrs)	300
Mkt. Cap (S\$m/US\$m)	192 / 141
Major Shareholders	
Hyflux Water Projects (%)	31.5
FMR LLC (%)	6.9
Schorders Invnt Mgmt (%)	6.8
Free Float (%)	54.8
Avg. Daily Vol. ('000)	421

Smooth sailing at the plants. We visited three HWT assets viz.

- Wastewater Treatment Plant (“WWTP”) at Langfang
- Wastewater Treatment Plant at Changshu
- Water Treatment Plant (“WTP”) at Guanyun

and came away satisfied with the pace of progress of both the existing portfolio and the pipeline-in-waiting. We now go into some of the details about the progress of these projects. We believe this would give investors a flavour of where our assumptions about portfolio ramp-up stand and a feel of how the growth prospects of the existing portfolio stack up.

Summary details of the plants we visited

Location	Province	Project Type	Capacity (cu m/day)	Remarks
Langfang	Hebei	WWTP	80,000	WWTP in operation, mainly domestic wastewater treatment, WRP completed and in testing phase
		WRP	40,000	
Changshu	Jiangsu	WWTP	30,000	WWTP in operation at about 70% utilisation, civil works of Phase II (another 30,000 MLD) completed
Guanyun	Jiangsu	WTP	100,000	Phase I (50,000 MLD) to start operations within one month, Phase II (50,000 MLD) under construction

Source: Company, DBS Vickers

Langfang story largely residential. The Langfang WWTP and adjoining WRP are situated in an emerging industrial zone at the outskirts of Langfang City. Langfang City is located in the Bohai Rim Economic Circle and Capital Economic Circle in Hebei Province. The WWTP was initially constructed by the Government in 2002 as a means of treating municipal wastewater for the whole of Langfang City, which has been developed as a neat, clean and green city. It was later sold to Hyflux in 2006 to be operated on a TOT basis.

Port – thus attracting people from nearby rural areas and other migrants to settle in. The concession area of the plant covers the entire city area, whose population has grown from about 300k in 2006 to 360k in 2007 (excluding about 100k migrant workers) and continues to grow further. Thus, growth in requirement of wastewater treatment is imminent.

Sedimentation tank – final treatment phase before discharge

Wastewater intake – first phase of treatment – grit removal



Source: DBS Vickers

The location of the city is very convenient, being close to both Beijing and Tianjin – 40 km from Beijing, 60 km from Tianjin, 60 km from Beijing Airport and 105 km from Tianjin



Source: DBS Vickers

Additional requirement will come from new industries in the area – including the Foxconn Phase I and Phase II factories. Discharge from upcoming industries would increase the capacity utilisation of the plant by another 20,000 cu m/day to almost 100% utilisation, once completed within the next 2 years.

Wastewater – before and after treatment!



Source: DBS Vickers

Changshu Plant supported by industrial park growth. This plant is located in the Changshu Southeast Economic Development Zone ("CSEDZ"), which is in the southeast of Changshu City, Jiangsu Province. CSEDZ is strategically located within reach of established industrial and commercial centres - about 80 km from Shanghai, 30 km from Suzhou and 40 km from Wuxi and is ranked among the top 5 industrial parks of the country.

Overview of Changshu WWTP



Source: DBS Vickers

CSEDZ has been an attractive investment location in the Yangtze River Delta and more than 190 foreign enterprises from 20 countries established in it since 2003, with contractual foreign capital exceeding US\$3b. The total concession area for HWT is about 57 sq. km and covers the

entire EDZ, providing an ideal platform for growth as more industries are established in the yet-unpopulated areas of the industrial park.

The oxidation tank – biological treatment of chemical waste



Source: DBS Vickers

Phase I of the WWTP (design capacity 30,000 cu m/day) is operational with capacity utilisation of more than 20,000 cu m/day and treats discharge from the adjoining textile, fine machinery, telecom, auto spares and electronics industries. Industrial wastewater contains more chemical effluents and requires more intensive treatment than municipal wastewater – hence tariff rates are usually higher. Civil works of Phase II of the WWTP (another 30,000 cu m/day) are completed, and will be commissioned as and when demand is sufficient.

Guanyun plant – part of the ROFOAR pipeline. This is a raw water treatment plant with a concession capacity of 100,000 cu m/day, sourcing water from the nearby Tingtang river and supplying to industries within the Guanyun EDZ (Phase I) and later to the nearby city (Phase II).

The EDZ was approved in April 2006, and since then has been attracting quite a few industries including auto spares, electronics, textiles etc. The Government has grand plans to develop the EDZ into an integrated city with green industries, and large residential and lifestyle developments within the next 10 years.

Phase I of the WTP has a design capacity of treating 50,000 cu m/day (minimum off-take 25,000 cu m/day) and is fully completed and in the final stages of testing. Operations and tariff collection should begin by July 2008. The second phase is being built alongside and should be completed by the end of 1Q09. These two WTPs, along with a WWTP being built

at a different location in the same EDZ are part of the portfolio of assets recently offered to HWT by Hyflux as part of the ROFOAR agreement.

Guanyun WTP Phase I – all ready to take off



Source: DBS Vickers

Guanyun WTP Phase II – civil works in progress



Source: DBS Vickers

Leveraging Hyflux’s strengths. Hyflux Water Trust has been leveraging the strengths of its sponsor to the fullest extent in order to manage its assets. Each of HWT’s plants (“SPCs” or Special Purpose Companies) has inked Operations & Maintenance (“O&M”) Agreements and Management Services (“MS”) Agreements with the Hyflux O&M Operators and Hyflux MS Providers, respectively. This allows HWT to benefit from the long track record and experience of Hyflux personnel in the water infrastructure industry.

Key responsibilities of the Hyflux O&M Operator:

- Plant operating, repairing, maintenance (scheduled & unscheduled) and other technical services
- O&M staff hiring, training, managing
- Commissioning plant before completion date
- Purchasing of chemicals, spares and tools
- Sampling, testing and recording incoming and discharging water quality
- Submitting records to government bodies on behalf of SPC and filing all the records

Key responsibilities of the Hyflux MS Provider:

- Responsible for external relationships (government relationship, ensuring water, electricity, heating supply etc.)
- MS staff hiring, training and managing
- Obtaining, keeping and managing licenses, government approvals etc.
- Responsible for tariff collection
- Making business plan & budgeting, monitoring execution
- Finance, tax, capital and auditing management
- Responsible for subcontractor tendering and bidding process
- Negotiating and applying for tariff adjustment

Costs in check, tariff adjustments possible if required. As we have pointed out in earlier reports, HWT has a few cost adjustment mechanisms already in place – specifically relating to sludge treatment fees, maintenance costs, chemical costs and general & administrative fees – wherein the cost increases, if any, are borne by the Hyflux O&M/ MS Operators unless there is a corresponding tariff adjustment. However, for manpower and electricity costs, HWT bears the full brunt. Of this, manpower costs for the Trust is largely limited by the very lean organizational structure. Any changes in the input and output water quality from pre-decided standards are also imputed into tariff adjustments automatically, as the concession agreement covers such clauses.

Moreover, HWT appears to be quite capable of negotiating tariff increases if operating costs increase beyond a certain limit, keeping in mind the excellent rapport shared by senior Management Services personnel and senior local Government officials. However, tariff increases are not a regular feature and there is no certainty, at the end of day,

whether the central pricing body approves a particular application. A certain degree of risk, thus, remains for HWT, especially in the current inflationary environment, where the Government may be more reluctant to increase tariffs of utilities/ essential commodities.

Acquisitions to back up organic growth? – The Hyflux offer.

The most pertinent question on everybody's minds right now, though, would be whether Hyflux Water Trust would accept Hyflux's offer of sale of 9 water and wastewater assets in China for a consideration of S\$180m.

The assets have a total design capacity of treating 290,000 cu m of water/day, which amounts to about 65% of HWT's IPO portfolio of 445,000 cu m/day. The portfolio on offer includes 4 WWTPs and 5 WTPs and the majority should be operational by 2Q09. According to our estimates, the total investment value of these 9 assets amount to S\$110m. This

indicates a potential divestment gain to Hyflux of about S\$70m.

HWT would now have to conduct operational, financial and legal due diligence on the relevant assets, as well as invite 3rd party independent valuation of the assets. Assuming that a decision in favour of the acquisition is reached by 3Q08, HWT can complete the acquisition by end-2008 after receiving the approval of its unitholders (since offer portfolio exceeds 5% of existing NAV).

Details of Portfolio offered by Hyflux to HWT as part of ROFOAR agreement

Project Location	Project Type	Projected Completion Date	Estimated Investment Value (S\$m)	Concession Capacity (m ³ /day)	Concession Type
Wuxi City, Jiangsu Province	WWTP	1Q-2008	6.1	10,000	BOT, 30 years
Guanyun, Jiangsu Province	WWTP	3Q-2008	11.1	30,000	BOT, 30 years
Guanyun, Jiangsu Province	WTP	3Q-2008	15.3	50,000	BOT, 30 years
Xuecheng District, Shandong Province	WTP	3Q-2008	15.9	30,000	TOT, 25 years
Xuecheng District, Shandong Province	WTP	3Q-2008		30,000	BOT, 25 years
Yangkou, Rudong, Jiangsu Province	WWTP	1Q-2009	10.9	20,000	BOT, 30 years
Lianyungang, Guanyun, Jiangsu	WTP	2Q-2009	19.8	50,000	BOT, 30 years
GongChangLing, Liaoning	WTP	2Q-2008	21.2	40,000	TOT, 30 years
Mingguang, Anhui Province	WWTP	2Q-2008	10.5	30,000	TOT, 30 years
Total			111	290,000	

Source: Company, DBS Vickers

To acquire or not to acquire? The key issues facing HWT management would be whether they are paying a fair price for the assets and whether they can arrange financing at rates attractive enough to render the asset injection yield accretive at the offer price.

Our take on the first issue is that the offer seems to be overpriced, at about 1.6x P/BV – compared to the valuation of the IPO portfolio of about 1.3x. The premium to IPO valuation cannot be justified in the current environment of rising costs coupled with uncertain tariff adjustments.

As to financing, HWT is currently un-g geared and has a US\$60m (~S\$82m) credit line to finance future acquisitions. The credit facility carries an interest rate of 98 basis points per annum above USD LIBOR (if US\$ loan) or SGD SOR (if S\$

loan). This makes it easier for HWT to arrange for additional debt to finance the deal under consideration. However, the interest rates payable will most certainly be considerably higher than that payable for existing credit facility.

Even if we are optimistic about the terms of new financing and assume a flat rate of 5% for the entire loan, the acquisition is yield accretive only from FY11 onwards and depresses DPU yields in FY09 and FY10. At 6% interest rate assumption, the yield accretion starts even later.

Thus, we conclude that though the Hyflux offer is positive by itself because it provides visibility on what kind of tranche size and timeline Hyflux is looking at, with respect to divestment of the ROFOAR assets, the offer price is too high to woo short-term investors. The acquisition would still be

Hyflux Water Trust

long-term yield accretive and our valuation for the Trust, assuming that acquisition is completed by end-2008 at current offer price, would range between S\$0.95-1.02 per unit. For now, our Target Price remains unchanged at

S\$0.90, based on our DDM calculations. Reiterate BUY. Expect a re-rating if Hyflux decides to go ahead with the acquisition.

How DPU stacks up with and without the acquisition*

DPU (S cents) – after applicable waivers	FY08F	FY09F	FY10F	FY11F	FY12F
Without acquisition (existing portfolio)	4.45	5.32	5.54	6.42	7.22
With acquisition	4.45	4.36	5.55	7.11	8.07

* Assuming full acquisition of assets at S\$180m offer price financed by debt at effective interest cost of 5%, completed by end-2008
 Source: DBS Vickers

Income Statement (\$\$ m)

FY Dec	2008F	2009F	2010F	2011F
Gross Revenue	52	38	40	43
Operating Expenses	(47)	(25)	(24)	(25)
Operating Profit	5	13	16	18
Other Operating Expenses	(1)	(2)	(2)	(2)
Other Non Opg (Exp)/Inc	0	0	0	0
Net Interest (Exp)/Inc	0	(1)	(1)	(1)
Exceptional Gain/(Loss)	0	0	0	0
Net Income	4	11	14	15
Tax	1	(2)	(2)	(2)
Minority Interest	0	0	0	0
Preference Dividend	0	0	0	0
Net Income	4	9	12	13
Non-tax deductible Items	3	4	4	4
Net Inc available for Dist.	9	16	18	21
Revenue Gth (%)	N/A	(27.8)	6.6	7.2
Operating Gth (%)	N/A	145.5	24.6	9.2
Net Inc Gth (%)	N/A	113.8	28.0	10.5
Dist. Payout Ratio (%)	100.0	100.0	90.0	90.0

Balance Sheet (\$\$ m)

FY Dec	2008F	2009F	2010F	2011F
Financial Receivable	100	97	94	91
Other LT Assets	118	117	113	109
Cash & ST Invts	27	21	24	24
Other Current Assets	9	7	8	8
Total Assets	253	242	238	232
ST Debt	0	0	0	0
Other Current Liabilities	22	18	19	21
LT Debt	10	10	10	10
Other LT Liabilities	14	13	12	12
Unit holders' funds	208	201	196	190
Minority Interests	0	0	0	0
Total Funds & Liabilities	253	242	238	232
Non-Cash Wkg. Capital	(13)	(11)	(12)	(13)
Net Cash/(Debt)	17	11	14	14

Cash Flow Statement (\$\$ m)

FY Dec	2008F	2009F	2010F	2011F
Pre-Tax Income	4	11	14	15
Dep. & Amort.	3	4	4	4
Tax Paid	0	0	(2)	(3)
Associates & JV Inc/(Loss)	0	0	0	0
Chg in Wkg.Cap.	(5)	(4)	1	1
Other Operating CF	0	0	0	0
Net Operating CF	2	11	16	17
Net Invnt in Properties	(33)	(3)	0	0
Other Invts (net)	(8)	3	3	3
Invts in Assoc. & JV	0	0	0	0
Div from Assoc. & JVs	0	0	0	0
Other Investing CF	0	0	0	0
Net Investing CF	(41)	0	3	3
Distribution Paid	(9)	(16)	(17)	(19)
Chg in Gross Debt	10	0	0	0
New units issued	(9)	0	0	0
Other Financing CF	0	0	0	0
Net Financing CF	(8)	(16)	(17)	(19)
Net Cashflow	(47)	(6)	3	1

Rates & Ratio

FY Dec	2008F	2009F	2010F	2011F
Operating Margins (%)	10.2	34.7	40.5	41.3
Net Income Margins (%)	8.1	24.0	28.8	29.7
Dist to revenue (%)	17.5	42.2	45.8	49.4
Managers & Trustee's fees to sales (%)	2.1	4.3	4.5	4.4
ROAE (%)	2.0	4.4	5.8	6.7
ROA (%)	1.7	3.7	4.8	5.5
ROCE (%)	2.0	4.8	6.2	7.0
Int. Cover (x)	9.0	14.6	17.1	19.4
Current Ratio (x)	1.7	1.6	1.6	1.6
Quick ratio (x)	1.6	1.5	1.5	1.5
Net Debt to Equity (X)	CASH	CASH	CASH	CASH
Operating CFPS (S cts)	2.2	4.8	5.2	5.4
Free CFPS (S cts)	(10.2)	2.4	5.4	5.7

Quarterly / Interim Income Statement (\$\$ m)

FY Dec	1Q2008
Gross Revenue	14
Operating Expenses	(13)
Operating Profit	1
Other Operating expenses	1
Other Non Opg (Exp)/Inc	0
Net Interest (Exp)/Inc	0
Exceptional Gain/(Loss)	1
Net Income	1
Tax	0
Minority Interest	1
Net Income after Tax	0
Total Return	0
Non-tax deductible Items	3
Net Inc available for Dist.	37
Revenue Gth (%)	N/A
N Property Inc Gth (%)	N/A
Net Inc Gth (%)	N/A
Net Prop Inc Margin (%)	8.1
Dist. Payout Ratio (%)	90.0

Source: Company, DBS Vickers

PE Chart (x)



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Tel. 65-6533 9688, Fax: 65-6226 8048
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