

# Singapore Industry Focus

## Water Sector

DBS Group Research . Equity

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### Margins paint a positive picture

**Cost concerns dealt with, for now.** As we had expected, our top picks in the sector demonstrated their ability to negotiate an inflationary environment and protect their margins, with gross margins across the board coming in better than consensus estimates in 2Q08. This bodes well for potential upside in margins in 2H08, given the extra buffer from softening in commodity prices and the recent cooling of crude oil prices.

**Orderbooks going strong, execution on track mostly.** Hyflux and Epure both reported very strong 2Q08 results, which is a testament to their execution capabilities, and we expect proportionately greater revenue recognition in 2H08 as they continue to deliver on their respective orderbooks of S\$1.5b and RMB 1b. Asia Environment was the exception here, with slower orderbook recognition in 2Q08 and perceived slower order win momentum, going forward.

**Other revenue streams coming on-stream.** Even though Asia Environment may face some short-term slowdown in contracts, revenues will be beefed up from 4Q08 onwards by O&M contributions from completing BOT projects like Nantong. Hyflux is also likely to benefit from divestment gains arising from sale of assets to Hyflux Water Trust ("HWT") by end-2008.

**Post-Olympics focus on infrastructure, looser monetary policy in China key catalysts.** We expect project momentum to pick up in China in the months following the Olympics as the Government re-focuses on priority infrastructure sectors like environmental services. With inflation no longer as much a concern as in 2Q08, we expect a pro-growth and more relaxed monetary stance in China to encourage private-public partnerships, thereby allowing the Singapore-listed water plays to bid for more capital-intensive BOT projects.

**Top picks remain Epure and Hyflux.** High growth potential for both these counters remain intact (expected EPS CAGR of 40% and 52%, respectively) and continued de-rating in line with the index has resulted in more attractive entry points valuation-wise. For value investors, we continue to recommend Hyflux Water Trust, which currently promises dividend yield in excess of 7%, in addition to a strong acquisition pipeline.

**POSITIVE** STI : 2,707.19

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#### TOP PICKS

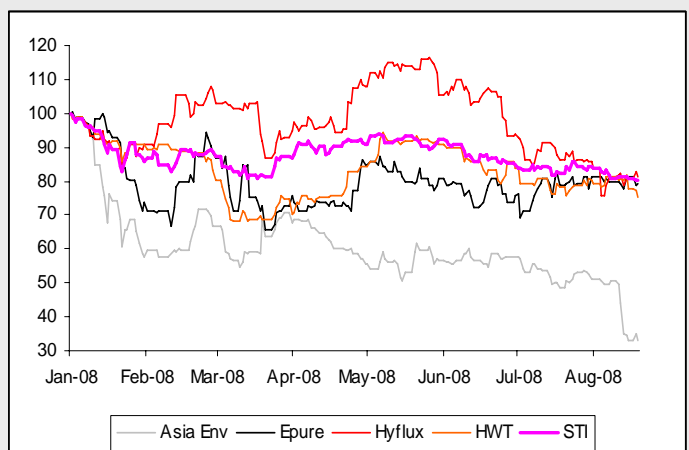
	Price S\$	Mkt Cap S\$	Target Price S\$	Rating
Epure International	0.565	729	0.93	BUY
Hyflux	2.79	1465	3.34	BUY

Source: DBS Vickers

**Epure International Ltd** : Epure is a turnkey water and wastewater treatment solution provider in the PRC

**Hyflux** : An integrated water and liquid treatment company specializing in membrane technologies.

#### Relative Price Performance of stocks in our water sector coverage



Source: Bloomberg, DBS Vickers

**Margin fears unfounded as Hyflux leads the way**

Though the market has more than priced in the effect of rising costs and uncertain tariff negotiations amidst an inflationary environment, 2Q08 results lend support to our belief that such concerns are not broad-based and some of these companies can effectively counter the cost pressures. 2Q08 gross margins for Hyflux, Epure and Asia Environment were indeed, better than consensus estimates and marginally better than 2Q07.

Hyflux's gross margin for the quarter was significantly better than 2Q07 (23.2%) and 1Q08 (12.9%) – achieved on the back of superior cost control of raw materials and economies of scale. We expect gross margin for the full year to normalize around 25%, which is still better than our initial conservative estimates of 21-22%. Thus, our fears about rising steel prices and project delays eating into margins were overstated, and so we believe, are the market's.

**2Q08 results for SGX-listed water companies (\$\$ m)**

	Revenue		Gross Profit		EBIT		Net Profit		Gross Margin	
	2Q08	yoy chg (%)	2Q08	yoy chg (%)	2Q08	yoy chg (%)	2Q08	yoy chg (%)	2Q08	yoy chg (ppt)
Asia Environment	110.4	-15	38.0	-14	21.9	-36	15.1	-48	34.4	0.5
Epure	239.5	86	77.1	87	69	53	52.1	56	32.2	0.2
Hyflux	108.1	139	39.2	275	28.6	524	22.6	311	36.3	13.1
Hyflux Water Trust	16.7	N/A	2.1	N/A	1.9	N/A	2.2	N/A	12.6	N/A

Source: Companies, DBS Vickers

**Smaller players may see short-term slowdown in order flow**

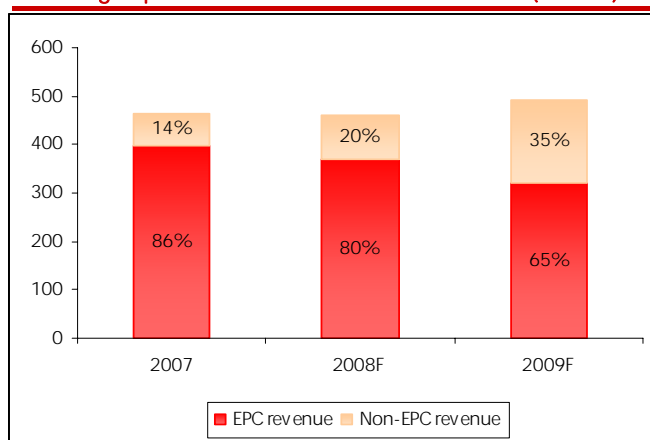
Smaller players like Asia Environment have warned of a slowdown in BOT order wins for the rest of the year, as a result of a lack of funding options, given the tight credit environment. With the current uncertain equity market sentiment, and without sufficient credit lines to back up an equity issue, capital recycling vehicles in the form of business trusts are unlikely to take off in the near future, as well. We expect Asia Environment's plans for listing its Trust to be delayed to mid-2009.

Trust ("HWT") by end-2008, which also helps beef up its capital structure to take on more gearing.

**But elsewhere, we are more positive about order flow...**

Hyflux (net gearing of 0.5x, set to reduce further by year-end on divestment of assets to HWT) and Epure (net cash position) are more than well positioned to tackle any short term credit market issues and YTD order win momentum has been promising. Epure's net order book was RMB 1.0b at end-2Q08, with YTD order wins of RMB 862m, very likely to exceed our FY08 order win assumption of RMB 900m. Hyflux is currently sitting on an orderbook of S\$1.5b, which includes about S\$900m worth of contracts outstanding in Algeria.

**Reducing dependence on EPC - Asia Environment (RMB m)**



Source: Company, DBS Vickers

**And other revenue streams are coming online as well**

Even though Asia Environment has slowed down its pace of securing new BOT projects, revenues will be beefed up from 4Q08 onwards by O&M contributions from completing BOT projects like Nantong. Hyflux is also likely to benefit from divestment gains arising from sale of assets to Hyflux Water

**2H08 revenues mostly in the bag, upside potential in margins**

As evident from the table below, the downside risk to revenues in 2H08 is relatively low, given the high proportion of revenue covered by existing secured orderbook. Moreover, with the recent cooling in oil prices and softening of commodity prices worldwide, the threat to margins from steel and cement prices has diminished significantly. Inflationary pressures are likely to cool off as well, making water tariff revisions easier than before.

### EPC orderbooks of water companies as at 1Q08

	Currency	YTD wins	EPC Order wins			Current backlog	Revenue covered by secured EPC orderbook		
			2006A	2007A	2008F		FY08F	FY09F	FY10F
Asia Environment	RMB m	180	410	431	320	400	69%	34%	-
Epure	RMB m	862	610	800	900	1000	95%	32%	3%
Hyflux	S\$ m	768	439	230	800	1500	79%	75%	40%

Source: Companies, DBS Vickers

#### Key catalysts would be big contract wins, special gains

The project flow is expected to gather renewed momentum in China post-Olympics as the Government re-focuses its attention to priority infrastructure sectors. As such, apart from the steady flow of opportunities that we expect – both from China and the MENA region, BOT tariffs and divestment gains are also expected to boost earnings over and above our expectations for companies like Hyflux.

#### Sector valuations continue to flow lower

Our basket of Singapore water stocks continued to lag the broad index YTD, with a 22.1% decline (market cap weighted) compared to the STI's 19.9% decline, in spite of the growth potential of most of the companies remaining pretty much intact over the period. Asia Environment stock fell about 40% in the last week following negative 2H08 outlook from management – while the other stocks have fallen in the range of 18-25% YTD.

The Singapore water sector is currently trading at more favourable valuations of 8.9x FY08 and 7.3x FY09 earnings, on consensus EPS growth of 17% and 13%, respectively – compared to HK/ China peers trading at 15.2x FY08 and 13.9x FY09 on EPS growth of -3% and 9%.

#### So it's a good time to accumulate top picks

Epure and Hyflux remain our top picks, with strong growth forecast of 40% and 52% respectively over the next 2 years, underpinned by healthy orderbooks, superior execution capability and astute management. We have a more cautious view on Asia Environment now, given the financing uncertainties, and have revised our recommendation to HOLD.

For value buyers, we continue to recommend Hyflux Water Trust, which promises current dividend yield in excess of 7% and is already in the process of evaluating and executing possible yield-accretive acquisitions from Hyflux in the near term.

### Singapore water peer valuations

Company	Crncy	Price	Adjusted Market Cap (USD m)	P/E (x)		EPS Growth (%)		PEG	P/B	ROE (%)	EV/ EBITDA	NET DEBT TO EQUITY (%)
				FY08	FY09	Curr Yr	Nxt Yr					
Asia Env	SGD	0.27	81.1	9.6	10.1	-24%	-4%	-0.9	0.7	17.4	13.3	-3.1
Epure	SGD	0.565	511.1	12.9	11.1	67%	17%	0.4	2.9	18.0	12.7	-35.9
Bio-Treat	SGD	0.205	128.1	3.2	2.0	19%	14%	0.2	0.5	18.3	5.4	34.0
Sinomem	SGD	0.4	129.5	5.3	4.7	14%	13%	-0.3	1.0	17.2	na	-10.3
Asia Water	SGD	0.105	14.5	2.4	2.3	-23%	5%	-0.3	0.3	14.9	14.6	65.7
Sinopipe	SGD	0.31	48.9	3.9	3.8	4%	3%	1.2	0.8	21.5	4.2	8.0
Hyflux	SGD	2.79	1027.5	24.7	17.4	63%	42%	0.5	5.3	15.0	26.8	31.5
Darco	SGD	0.13	20.5	na	na	na	na	na	0.6	7.1	11.0	-79.0
Dayen	SGD	0.14	20.1	na	na	na	na	na	1.2	-36.4	na	51.7
Pan Asian	SGD	0.135	11.8	na	na	na	na	na	1.2	6.2	8.4	-15.2
<b>Singapore Average</b>				<b>8.9</b>	<b>7.3</b>	<b>17%</b>	<b>13%</b>	<b>0.1</b>	<b>1.4</b>	<b>9.9</b>	<b>12.1</b>	<b>4.7</b>

Source: Bloomberg, DBS Vickers

Industry Focus  
**Water Sector**

**Stocks under coverage in the water sector with >US\$100m market capitalisation each**

SGX-listed companies	2Q 2008 - Actual results vs. expectation	Comments	Target Price	Ratings	Price catalysts
Epure International	Above	1) Epure's net profit for 2Q08 rose 56% y-o-y to RMB52.1m. 2) Revenue rose 86% y-o-y to RMB239.5m in 2Q08, with contribution from 5 major projects. 3) Gross profit margin increased 0.2ppt y-o-y to 32.2%, due to strong project execution.	\$S0.93	BUY	1) More EPC contracts announcement in the PRC. 2) Positive updates on the Chinese government's final clearance of Epure's tax exempt status for its subsidiary, Beijing Epure International Water Co., Ltd (BEI). 3) Strong execution of contracts that justifies its scarcity premium as a consistent SGX-listed water performer.
Hyflux	Above	1) Strong set of results, with quarterly revenue exceeding S\$100m for the first time at S\$108m (up 139%) and net earnings of S\$23.9m up almost four-fold. 2) Gross margin outperformed at 36.3%, significantly better than 2Q07 (23.2%) and 1Q08 (12.9%), due to better cost controls	\$S3.34	BUY	1) More contributions from Algeria projects 2) Better-than-expected gross margins for the full year 3) Strong order win momentum in the international arena, cementing Hyflux's global brand status 4) Divestment gains from sale of assets to HWT
Hyflux Water Trust	Above	1) 2Q08 net earnings of S\$2.2m (up 94% q-o-q), net 1H08 cash payout to investors of 2.17 cents per unit better than IPO projection 2) Tariff receipts up 19% q-o-q, operating margins improved sequentially from 48% to 68%	\$S0.90	BUY	1) 3 more plants completing by end-2008, utilisation rates to move up to 70% from 63% currently  2) Potential successful negotiation of organic expansion of capacity for 4 plants by a combined 155,000 cu m/day 3) Injection of pipeline assets from sponsor, in tranches
Asia Environment	Below	1) Net earnings were down 48% to RMB 15m while revenue declined 15% y-o-y to RMB 110m 2) While gross margin was stable at 34%, lower revenue recognition combined with higher SG&A expenses, higher finance costs and higher taxes led to lower profits	\$S0.42	HOLD	1) Share price weakness expected on project finance concerns and sentiment is unlikely to improve in 2H08, given the uncertainty in order wins 2) Group is in the process of negotiating 2 contracts similar in size to Nancheng project, which should be closed by year-end if financing is in place

Source: DBS Vickers

DBSV recommendations are based on an Absolute Total Return\* Rating system, defined as follows:

**STRONG BUY** (>20% total return over the next 3 months, with identifiable share price catalysts within this time frame)

**BUY** (>15% total return over the next 12 months for small caps, >10% for large caps)

**HOLD** (0-15% total return over the next 12 months for small caps, 0-10% for large caps)

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*Share price appreciation + dividends*

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