OCBC Bank

Earnings Review: CITIC Envirotech Ltd ("CEL")

Asia Credit Research

Issuer Profile: Neutral (5)

Ticker: **CELSP**

Background

CITIC Envirotech Ltd ("CEL") is an integrated water treatment solutions provider focusing on the Chinese market. CEL operates in three main business segments: Engineering, Treatment and Membrane. The company is listed on the SGX and is ~54%-owned by CITIC, a central government SOE. China Reform Fund Management Co. Ltd has a deemed interest of ~23.6% (via investment funds).

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Recommendation

- CEL's 1Q2019 results were dragged by project delays though construction works for one of the affected projects has commenced post quarter end. While we are not overly concern over such delays in the near term (as they help reduce cash outflow), adverse project execution though may impact bankability down the road.
- CEL continues to face large capital commitments which limit the ability in generating free cash flow though access to debt financing has improved markedly since October 2018 and as such we are maintaining our **issuer profile of Neutral (5)** on CEL.
- Aside from the improvement to CEL's financial flexibility, we have not factored in state support in our Neutral (5) issuer profile of CEL. CEL's debt is not explicitly guaranteed by CITIC and/or the state while CEL remains a small part of the CITIC behemoth.
- The perpetuals come with a high step up of 500bps if not called in October 2020 and rank *pari passu* with all other present and future unsecured obligations of the issuer, our base case remains that CEL would call the perpetual at first call.
- On the back of widened spreads since early-May 2019, we are lifting our underweight call on the CELSP 3.9%-PERP to neutral. There is no perfect comparable for the issuer in the SGD-space although Frasers Property Limited (Issuer Profile: Neutral (4)) has a perpetual with a first call in March 2020. In our view, the 30bps spread differential compensates for CEL's somewhat weaker credit profile and seven months longer first call date.

Relative Value:

Bond	Maturity/Call date	Net gearing[1]	Ask Yield to Maturity/ Ask Yield to Call	Spread (bps)
CELSP 3.9%-PERP	19/10/2020	0.80x	4.63%	272
FPLSP 5.0%-PERP	09/03/2020	0.87x	4.37%	242
HPLSP 4.65%-PERP	05/05/2022	0.26x	4.79%	289

Indicative prices as at 17 May 2019 Source: Bloomberg
(1) Net gearing based on latest available financials, unadjusted basis

Key Considerations

- **1Q2019 results plagued by project delays:** CEL's gross revenue was down by 72.2% to SGD72.1mn in 1Q2019 mainly due to the decline in the Engineering business which saw revenue of just SGD6.9mn against SGD121.9mn in 1Q2018. Additionally, Membrane system sales were SGD13.7mn in 1Q2019, also significantly lower versus SGD90.9mn in 1Q2018. Per company the decline of Engineering and Membrane system sales was due to delay of construction works on two large projects (Meigu County and Lanzhou City) due to adverse weather conditions. Meigu County is a mountainous rural area in Sichuan Province where the contract is an ecological restoration project (contract amount of ~SGD515mn). The contract for Lanzhou City (capital city of Gansu Province) has multiple components. The original contract amount was RMB4.6bn (~SGD916mn) though RMB1.8bn (~SGD358mn) relating to the land remediation component has been since terminated via mutual agreement. Treatment revenue (the most stable part of the business) was SGD51.5mn in 1Q2019, rising 11% y/y.

- **Keeping alert albeit imperfect information:** For now, we are not overly concern over the delays as these slow down CEL's considerable investment outlay (ie: conserves cash amidst the upcoming first call date of CELSP 3.9%-PERP in 17 months' time) while one of the project has commenced post quarter end. Detailed contract-by-contract return breakdown and progress timelines are undisclosed, though we are keeping an eye on any further adverse signals on contract execution which impacts medium term bankability.

- **Interest expense higher:** Driven by the decline in revenue from Engineering and Membrane system, EBITDA (based on our calculation) was meagre in 1Q2019 at

SGD12.9mn versus SGD61.7mn in 1Q2018 and insufficient to cover interest expense during the quarter which had increased to SGD16.9mn from SGD9.3mn in 1Q2018. The increase in interest expense was in line with the increase in average debt balance in 1Q2019 versus 1Q2018 as CEL had redeemed its USD perpetual with debt in November 2018. As at 31 March 2019, perpetuals only made up 8% of total capital versus 26% as at 31 March 2018.

- **Large working capital and investment outlay:** In 1Q2019, CEL recorded negative cash flow from operations (before interest but after tax) of SGD49.0mn driven by outlays from its capital intensive Engineering business where payments are only received at a later date. In end-2018, CEL's consolidated capital commitment was SGD709.9mn, although year to date, the company has announced new contracts. Including new contracts, we estimate that the consolidated capital commitment has increased to SGD1.0bn – SGD1.1bn, necessitating CEL to continue tapping financing markets and we continue to expect an increasing leverage trend at CEL. As at 31 March 2019, CEL's unadjusted net gearing was 0.8x, increasing from 0.7x while adjusting for perpetual as debt which we think is a better reflection of leverage levels at CEL, this was 1.2x.

- **Manageable short term debt due:** As at 31 March 2019, short term debt at CEL was SGD252.7mn, representing only 17% of total debt (end-2018: short term debt was 27% of total debt). In 1Q2019, CEL had paid down SGD131.0mn of debt, including an early repayment of a bank loan in February 2019. Additionally, cash balance at CEL was SGD397.1mn as at 31 March 2019 which is more than enough to cover the short term debt due.

- **Access to debt financing has improved post alignment with CITIC:** In October 2018, CEL entered into an interested party transaction with its sister company, CITIC Finance Company Limited ("CITIC Finance"), a non-bank financial institution where CITIC Finance has extended unsecured loan facilities to CEL of up to RMB10bn and USD240mn (collectively ~SGD2.3bn). In our view, this is an indication of alignment of interest between CEL and the broader CITIC group and a credit positive. Per company ~SGD1.8bn in committed facilities remains unutilized, from the remaining CITIC Finance facility and a new facility from another lender. For the avoidance of doubt, CEL's debt is not explicitly guaranteed by its parent company and/or the state. Additionally, CEL is still a small part of CITIC, a conglomerate whose net assets was ~SGD141bn as at 31 December 2018. As such, while CEL's financial flexibility has improved, we have not factored in state support in our Neutral (5) issuer profile of CEL. In contrast, CITIC (Issuer Profile: Unrated)'s external ratings have been notched up from expectations of state support.

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Explanation of Issuer Profile Rating ("IPR") / Issuer Profile Score ("IPS")

Positive ("Pos") – The issuer's credit profile is either strong on an absolute basis, or expected to improve to a strong position over the next six months.

Neutral ("N") – The issuer's credit profile is fair on an absolute basis, or expected to improve / deteriorate to a fair level over the next six months.

Negative ("Neg") – The issuer's credit profile is either weaker or highly geared on an absolute basis, or expected to deteriorate to a weak or highly geared position over the next six months.

To better differentiate relative credit quality of the issuers under our coverage, we have further sub-divided our Issuer Profile Ratings ("IPR") into a 7 point Issuer Profile Score ("IPS") scale.

IPR	Positive		Neutral			Negative	
IPS	1	2	3	4	5	6	7

Explanation of Bond Recommendation

Overweight ("OW") – The performance of the issuer's specific bond is expected to outperform the issuer's other bonds, or the bonds of other issuers either operating in the same sector or in a different sector but with similar tenor over the next six months.

Neutral ("N") – The performance of the issuer's specific bond is expected to perform in line with the issuer's other bonds, or the bonds of other issuers either operating in the same sector or in a different sector but with similar tenor over the next six months.

Underweight ("UW") – The performance of the issuer's specific bond is expected to underperform the issuer's other bonds, or the bonds of other issuers either operating in the same sector or in a different sector but with similar tenor over the next six months.

Other

Suspension – We may suspend our issuer rating and bond level recommendation on specific issuers from time to time when OCBC is engaged in other business activities with the issuer. Examples of such activities include acting as a joint lead manager or book runner in a new issue or as an agent in a consent solicitation exercise. We will resume our coverage once these activities are completed.

Withdrawal ("WD") – We may withdraw our issuer rating and bond level recommendation on specific issuers from time to time when corporate actions are announced but the outcome of these actions are highly uncertain. We will resume our coverage once there is sufficient clarity in our view on the impact of the proposed action.

Analyst Declaration

The analyst(s) who wrote this report and/or her or his respective connected persons did not hold financial interests in the above-mentioned issuer or company as at the time of the publication of this report.

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