Asia Credit Research

OCBC Bank

CITIC Envirotech Ltd: Credit Update

Tuesday, 15 March 2016

Winning contracts amidst pronounced macro uncertainty

- **Contract wins continues to be commendable:** During the 9MFY2016 period, CITIC Envirotech reported a small decline in revenue at SGD274.8m vis-à-vis SGD287.8m reported in 9MFY2015. This was driven by a decline in the lumpier EPC segment where the company provides water-related engineering services to third parties. The combined effects of higher employee expense and financing costs led to a decline in net profit for the year to SGD42.6m (9MFY2014: SGD53.6m). Since 1HFY2016 to date, the company has managed to secure ~SGD346m worth of projects, including a maiden project in Indonesia worth SGD35m. All the other new contracts have been entered into with local governments and local government-linked units in China as grantors. With funding secured for the projects, these contracts will underpin the uptrend within the water treatment business for the next 12 months. Future contracts are likely to continue to come from heavily industrialised locales where the company's membrane technology has a distinct advantage versus its competitors. We expect EBITDA margins to hold steady at above 40% in light of the company's integrated model.

- **Counterparty credit risk manageable for now:** As of March 2016, the company's asset portfolio is comprised of 44 plants. We estimate that collectively, ~75% of plants by total design capacity (translated for higher per cubic metre tariff contribution from industrial water vis-à-vis municipal water) are located in the provinces of Hebei, Jiangsu, Shandong and Liaoning. Despite the significant measures taken by the central government to manage local government debt burden, the narrow-base revenue collection capacities of these counterparties remains unresolved. Nevertheless, we note that water sector operators have yet to experience any marked delays in collections.

- **Weaker cash flow coverage:** Overall, we saw an improvement in leverage ratios but a weaker operating cash flow profile. Gross debt increased to SGD746m from SGD700m as at 1HFY2016, however, debt-to-equity decreased to 0.65x (1HFY2016: 0.79x), as higher accounting profits were recognised during 3QFY2016. Despite earnings decreasing only by SGD4.3m, CFO for the 9MFY2016 decreased to SGD20.5m (9MFY2015: SGD49.1m), driven by higher cash tied up as deposits for project tenders and acquisition. As a corollary, CFO/Interest Expense decreased to 1.1x (9MFY2015: 3.5x). On a pro-forma basis assuming that the distribution on the perpetual securities had been applicable for the full 9MFY2016 period, we find that CFO/(Interest Expense plus Perpetual Distribution) to be 0.7x (note that CITIC need only comply with EBITDA interest covenants). ~SGD98m of bonds issued in August 2013 will come due in September 2016; this is likely to be replaced by new debt and/or a perpetual security issuance, which in our view should be manageable. We believe the company's service concession receivables amounting to SGD509.2m as at 9MFY2016 provides financial flexibility for the obtainment of secured financing, if required.

- **Recommendation**: While we continue to view the strategic importance of the water treatment industry and parental support of CITIC Ltd (majority owned by the Chinese government) favourably, the following are factors imposing a ceiling on further upside (i) heightened volatility risk over the RMB, which currently contributes ~100% of Citic Envirotech's operating cash flow against obligations on its foreign denominated debt and perp security (ii) deceleration of the Chinese industrial and manufacturing sector and (iii) uncertainties from on-going re-organisation of the state-owned sector. We are lowering CITIC Envirotech's issuer profile to **Neutral** from Positive.

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CITIC Envirotech Ltd

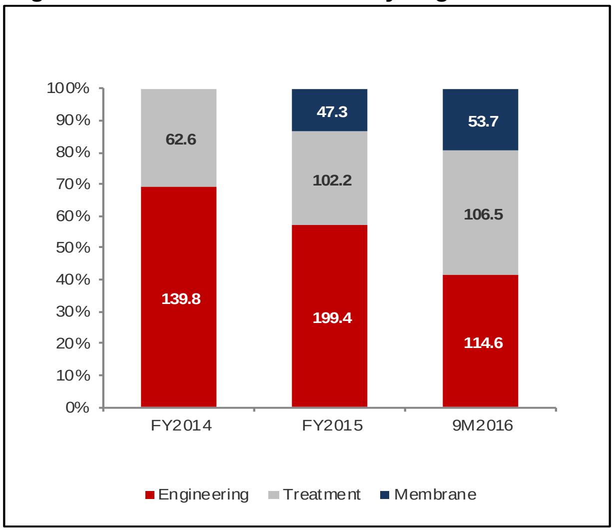
Table 1: Summary Financials

Year End 31st Mar	FY2014	FY2015	9M2016
Income Statement (SGD'mn)			
Revenue	202.3	349.0	274.8
EBITDA	81.2	138.9	126.1
EBIT	74.9	125.7	110.1
Gross interest expense	17.6	29.0	29.2
Profit Before Tax	31.2	79.9	61.5
Net profit	20.1	59.3	40.8
Balance Sheet (SGD'mn)			
Cash and bank deposits	141.7	113.8	540.5
Total assets	786.5	1,386.7	2,172.9
Gross debt	181.7	319.2	745.7
Net debt	40.0	205.5	205.2
Shareholders' equity	319.2	741.3	1,140.8
Total capitalization	500.9	1,060.6	1,886.4
Net capitalization	359.2	946.8	1,346.0
Cash Flow (SGD'mn)			
Funds from operations (FFO)	26.3	72.4	56.7
CFO	84.4	55.0	20.5
Capex	1.5	10.1	76.9
Acquisitions	0.3	22.3	96.7
Disposals	6.9	6.2	0.1
Dividend	3.0	2.7	5.6
Free Cash Flow (FCF)	82.9	44.9	-56.5
FCF adjusted	86.5	26.1	-158.7
Key Ratios			
EBITDA margin (%)	40.1	39.8	45.9
Net margin (%)	9.9	17.0	14.8
Gross debt to EBITDA (x)	2.2	2.3	4.4
Net debt to EBITDA (x)	0.5	1.5	1.2
Gross Debt to Equity (x)	0.57	0.43	0.65
Net Debt to Equity (x)	0.1	0.3	0.2
Gross debt/total capitalisation (%)	36.3	30.1	39.5
Net debt/net capitalisation (%)	11.1	21.7	15.2
Cash/current borrowings (x)	9.2	1.9	1.6
EBITDA/Total Interest (x)	4.6	4.8	4.3

Source: Company, OCBC estimates

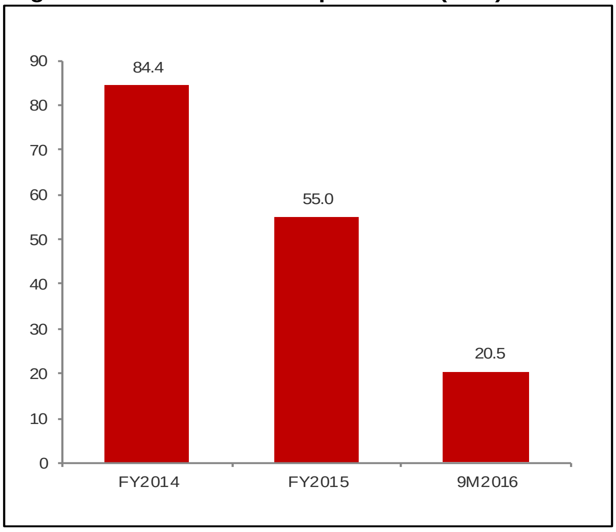
** FCF Adjusted = FCF - Acquisitions - Dividends + Disposals*

Figure 1: Revenue breakdown by Segment - 9M2016



Source: Company

Figure 2: Cashflow from Operations (CFO) in SGD'mn



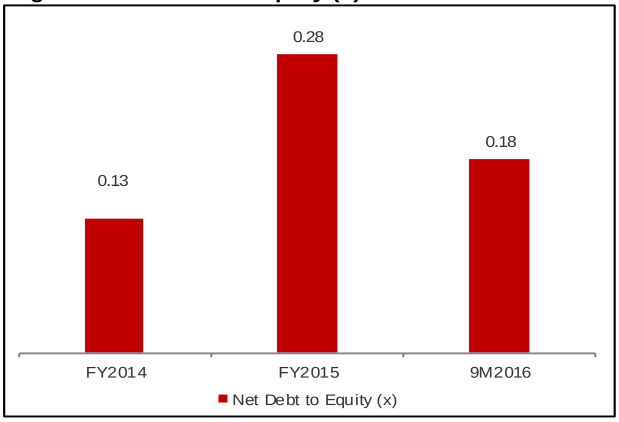
Source: Company

Figure 3: Debt Maturity Profile

Amounts in (SGD'mn)	As at 31/12/2015	% of debt
Amount repayable in one year or less, or on demand		
Secured	234.1	31.4%
Unsecured	100.9	13.5%
	335.0	**44.9%**
Amount repayable after a year		
Secured	173.8	23.3%
Unsecured	237.3	31.8%
	411.1	**55.1%**
Total	**746.1**	**100.0%**

Source: Company

Figure 4: Net Debt to Equity (x)



Source: Company, OCBC estimates

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