Asia Credit Research

Earnings Review: CITIC Envirotech Ltd ("CEL")

Recommendation

- Despite the strong income growth, this has not translated into a stronger credit profile, in light of CEL being in a high growth phase. As at end-2017, CEL faces SGD1.3bn in investment commitments and we expect CEL to become a more levered issuer.
- We maintain CEL's issuer profile at Neutral (4). CEL operates in a strategic sector, though we do not factor in further state support for CEL in determining our issuer profile.
- Despite the optical difference in net gearing, we think CELSP's net gearing is on the uptrend. A switch into Frasers Property Limited's FPLSP 5.0%-PERP would allow a similar yield with a seven month shorter call date. Notwithstanding that CELSP 3.9%-PERP comes with a high step up margin (which economically encourages a call), we are more comfortable over FPLSP's ability to generate recurring income from its underlying REITs.
- We also hold Frasers Property Limited's issuer profile at Neutral (4).

Issuer Profile: Neutral (4)

Relative Value:

Bond	Maturity/Call date	Net gearing (%)	Ask Yield	Spread
CELSP 3.9%-PERP	19/10/2020	10.0	4.35%	227
FPLSP 5.0%-PERP	09/03/2020	97.7	4.36%	237

Indicative prices as at 30 April 2018 Source: Bloomberg
Net gearing based on latest available quarter

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 ~62.9%-owned by CITIC, a central government SOE China Reform Fund Management Co. Ltd is deemed interested in ~23.6% of CEL (via investment funds).

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Key Considerations

- **Stronger top line growth:** CEL reported 1Q2018 results with total revenues up 133.1% y/y to SGD259.2mn. Revenue growth occurred across all segments with continued growth in the Engineering (+127% y/y) and Treatment (+23% y/y) segments while Membrane system segment performance reversed against FY2017 trends (- 50.3% y/y in FY2017) with sales up 361% y/y in 1Q2018. As such, Membrane system segment performance was the largest driver of y/y quarterly revenue growth. CEL ended the period with profit for the period attributable to owners of the company at SGD39.3mn (140.5% higher y/y) while currency translation gains was SGD17.9mn versus a translation loss of SGD23.2mn in 1Q2017, resulting in total comprehensive income of SGD59.7mn against a total comprehensive loss of SGD6.1mn in 1Q2017. Since 2017, the nature of CEL's revenue stream has intensified to one driven by engineering revenue against treatment (engineering contributed 76% to revenue in 2017 versus 56% in 2016).

- **Interest coverage improved from strong earnings:** With revenue growth attributed to large and numerous project wins since 2016, expenses have also risen with materials purchased, consumables used and subcontractors' fees up 148.6% y/y and gross profit up 109% y/y. SGA expenses though rose only 3.5% and as such, EBITDA (based on our calculation which does not include other operating expenses and other income) improved 152.6% y/y to SGD77.8mn. Interest coverage as measured by EBITDA/Interest was higher at 8.4x (1Q2017: 5.4x), this was despite interest expense increasing 50.4% to SGD9.3mn mainly as a result of higher borrowings taken at CEL. Assuming SGD35.0mn in perpetual distribution is paid out per annum and taking half of that as interest, we find adjusted EBITDA/Interest at 5.7x for 1Q2018.

- **High investing needs:** During the quarter, CEL's cash used in operating activities (before tax and interest) ("CFO") was an outflow of SGD57.2mn (1Q2017 CFO: outflow of SGD11.3mn), while investing outflows was SGD29.3mn. The cash gap at CEL was funded mainly by the equity raising and drawing down SGD66.6mn in existing cash. As at end-March 2018, CEL's cash balance had declined to SGD568.0mn versus SGD631.3mn in end-2017. In FY2017, CEL won more than RMB10.0bn (~SGD2.1bn) in contracts and while significant engineering revenue from these contracts can be recognised upfront, the operating cash inflow from such projects tends to occur over a long-term period. In end-2017, commitments to be undertaken by CEL on investment projects total SGD1.3bn (up from SGD378.5mn in end-2016). Assuming a 70:30 debt-to-equity/perpetual funding structure, we expect CEL to take on a significant amount of debt at the project level.

- **CEL is more levered than it appears:** Optically, CEL's net gearing appears low. As at 31 March 2018, we find CEL's unadjusted net gearing at 0.1x (31 December 2017: 0.1x). The use of perpetuals is significant at CEL, with perpetuals making up 26% of total capital as at 31 March 2018, adjusting net debt upwards for the perpetuals which in our view is more debt-like (contains onerous step-up and rank *pari passu* with all other unsecured obligations of the issuer), we find adjusted net gearing at 0.7x (31 December 2017: 0.8x), marginally improved due to solid earnings and the previously announced equity placement of new shares in CEL to New Resources LLC (raised SGD70.7mn). We see the income from waste water treatment as being the more stable cash flow generative portion of CEL. This was SGD141.0mn and SGD121.2mn in 2017 and 2016 respectively. CEL faces interest burden of ~SGD37.0mn p.a (annualising from 1Q2018) and assuming perpetual holders are paid, a further ~SGD35.0mn p.a in distributions. Conservatively, we assume that SGD928.0mn in new debt is taken to fund the commitments on investments while existing cash balance is used to fund the equity portion of the investments. In our view, adjusted net gearing would progressively increase as the commitments are carried out, potentially more than doubling from current levels.

- **Short term debt coming due manageable:** As at 31 March 2018, SGD421.2mn in short term debt was coming due, of these SGD224.8mn relates to the CELSP '18s which was due in April 2018 (this has since been redeemed). The remaining short-term debt relates to secured bank loans taken at subsidiaries. We see short term debt as manageable given the existing cash balance of SGD343.3mn (assuming that the SGD224.8mn in cash had been used to redeem the CELSP '18s).

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Explanation of Issuer Profile Rating / Issuer Profile Score

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 into a 7 point Issuer Profile Score 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.

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