

Last Closing: HK\$ 3.30

Upside: +16%

Target Price: HK\$ 3.83 ↑

Environmental Sector

Yunnan Water (6839 HK)

Expect more earnings improvement in FY18; upgrade to Buy

UP MP OP

Financial Highlights

Y/E 31 Dec	2015	2016	2017E	2018E	2019E
Revenue (RMB m)	1,558	2,866	5,087	6,059	6,855
YoY growth (%)	41.6	83.9	77.5	19.1	13.1
Net profit (RMB m)	286	388	420	471	573
EPS (RMB)	0.240	0.325	0.352	0.395	0.480
EPS growth (%)	24.1	35.8	8.3	12.0	21.7
P/E (x)	11.3	8.4	7.7	6.9	5.7
BVPS (RMB)	3.40	3.55	3.81	4.13	4.53
P/B (x)	0.8	0.8	0.7	0.7	0.6
Dividend yield (%)	3.7	3.7	2.6	2.9	3.5

Source: Company data, BOCOM Int'l estimates

- New contribution from PPP; GNS' profitability on track to improve.** We have reviewed our forecast after we identified new positives in a recent update with management. First, we expect more revenue contribution (in EPC and equipment sales segments) from PPP projects in FY18 after factoring in Yunnan Water's (YNW) newly obtained projects in Henan and Sichuan. Together with improved progress of other PPP projects, we expect a ~RMB1bn increment in FY18 revenue vs. our previous forecast. Meanwhile, management indicated operation of the Galaxy NewSpring (GNS) projects has improved since 2H17. We now expect a turnaround of the GNS projects in 2H17 and ongoing GPM improvement for YNW in FY18E, thanks to YNW's efforts in expense cut and operational improvement.
- Update on capital injection plan from major shareholder.** We still expect Yunnan Metropolitan Construction Investment (YMCI), YNW's controlling shareholder, to stick to its plan of capital injection in YNW by way of new shares subscription. As the issue of new shares requires NDRC approval, we believe the process will require at least one quarter. Nevertheless, management expects the capital injection plan could be finalized in 1H18.
- Lift FY17-19E earnings by 6-15%.** We lift FY17/18/19E net profit forecast by 6%/15%/8% after factoring in: (i) new contribution from PPP projects; (ii) profitability improvement from GNS projects; and (iii) more interest cost capitalized due to better progress in construction works. We now estimate YNW to achieve a 14% earnings CAGR in FY16-19E.
- Upgrade to Buy with TP raised to HK\$3.83.** We maintain our valuation benchmark of 8x 2018E P/E, which is 1 S.D. below historical average forward P/E. We lift TP from HK\$3.50 to HK\$3.83 based on our change in EPS estimate. YNW has underperformed the broad market and HK environmental peers since 2Q17, largely due to the disappointing 1H17 results. We now expect a gradual re-rating based on the early signs of improvement in GNS' earnings visibility and better progress in PPP projects. Given increased share price upside, we upgrade YNW from Neutral to **Buy**.



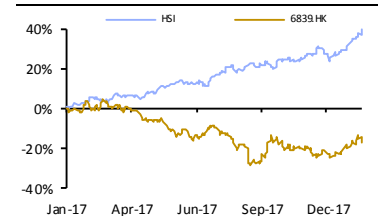
- We expect more contribution from new PPP projects in FY18 and operational improvement on GNS projects starting 2H17.
- We lift FY17/18/19 earnings forecast by 6%/15%/8%.
- Capital injection plan from YMCI should be finalized in 1H18E.
- Lift TP to HK\$3.83; upgrade to Buy.

Stock data

52w high (HK\$)	4.25
52w low (HK\$)	2.85
Market cap (HK\$ m)	3,937
Issued shares (m)	1,193
Avg daily vol (m)	0.82
1-mth change (%)	7.8
YTD change (%)	2.8
50d MA (HK\$)	3.16
200d MA (HK\$)	3.37
14-day RSI	56.95

Source: Bloomberg

1 Year Performance chart



Source: Bloomberg

Wallace Cheng
 wallace.cheng@bocomgroup.com
 Tel: (852) 3766 1810

Figure 1: Revenue and gross profit forecast

(RMB m)	Old			New			Change (%)		
	2017E	2018E	2019E	2017E	2018E	2019E	2017E	2018E	2019E
Revenue									
Wastewater treatment	1,061	894	874	1,061	894	874	0.0	0.0	0.0
Water supply	1,368	710	658	1,368	710	658	0.0	0.0	0.0
Solid waste	635	811	947	635	811	947	0.0	0.0	0.0
EPC & equipment sales	1,779	2,552	3,206	1,961	3,581	4,313	10.2	40.3	34.5
O&M	62	62	62	62	62	62	0.0	0.0	0.0
Total	4,905	5,029	5,748	5,087	6,059	6,855	3.7	20.5	19.3
Gross profit									
Wastewater treatment	411	471	538	414	474	541	0.7	0.6	0.6
Water supply	218	164	197	224	171	197	2.8	4.3	0.0
Solid waste	207	261	286	207	261	286	0.0	0.0	0.0
EPC & equipment sales	350	505	635	387	711	857	10.6	40.8	35.0
O&M	10	10	10	10	10	10	0.0	0.0	0.0
Total	1,196	1,410	1,666	1,243	1,627	1,891	3.9	15.4	13.5
Gross margin (%)									
Wastewater treatment	38.7	52.7	61.5	39.0	53.0	61.9			
Water supply	15.9	23.1	29.9	16.4	24.1	29.9			
Solid waste	32.7	32.1	30.2	32.7	32.1	30.2			
EPC & equipment sales	19.7	19.8	19.8	19.7	19.8	19.9			
O&M	16.0	16.0	16.0	16.0	16.0	16.0			
Overall gross margin	24.4	28.0	29.0	24.4	26.8	27.6			

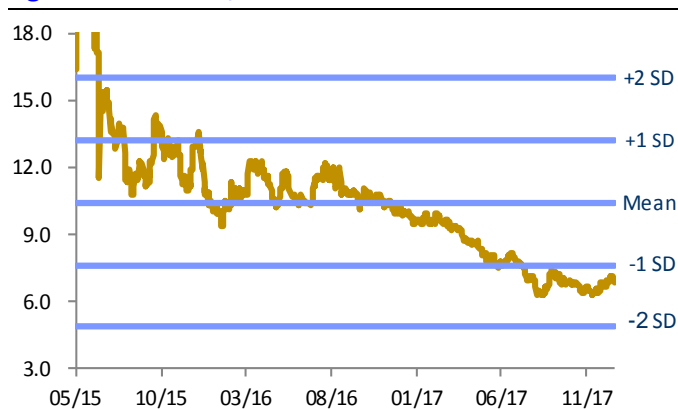
Source: Company data, BOCOM Int'l estimates

Figure 2: Change in forecast

	Old forecast			New forecast			Change (%)		
	2017E	2018E	2019E	2017E	2018E	2019E	2017E	2018E	2019E
Revenue (RMB m)	4,905	5,029	5,748	5,087	6,059	6,855	3.7	20.5	19.3
Net profit (RMB m)	395	410	530	420	471	573	6.4	14.8	8.1
EPS (RMB)	0.331	0.343	0.444	0.352	0.395	0.480	6.4	14.8	8.1

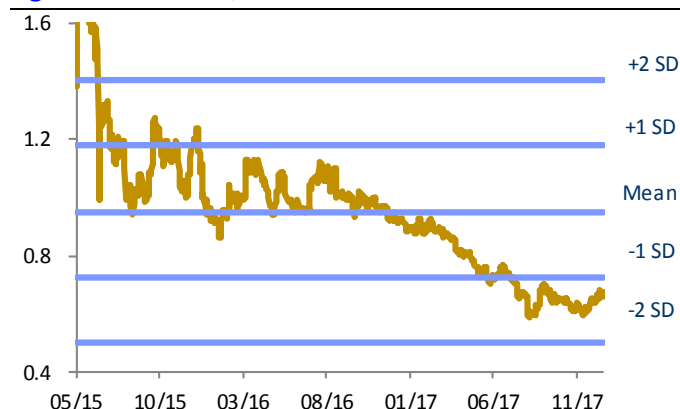
Source: BOCOM Int'l estimates

Figure 3: Forward P/E band of YNW



Source: Bloomberg, BOCOM Int'l

Figure 4: Forward P/B band of YNW



Source: Bloomberg, BOCOM Int'l

Company background

Yunnan Water is one of the leading integrated environmental service providers in municipal wastewater treatment and water supply industries in Yunnan Province. Major shareholders are Yunnan Metropolitan Construction (under Yunnan SASAC) and Beijing Origin Water (300070 CH; NR).

Yunnan Water (6839 HK): Financial Statements

Profit & loss (RMB m)

Year ended 31 Dec	2015	2016	2017E	2018E	2019E
Wastewater treatment	420	628	1,061	894	874
Water supply	455	639	1,368	710	658
EPC & equip sales	597	1,110	1,961	3,581	4,313
O&M	79	63	62	62	62
Solid waste	8	425	635	811	947
Turnover	1,558	2,866	5,087	6,059	6,855
COGS	(1,051)	(1,986)	(3,845)	(4,432)	(4,964)
Gross profit	508	880	1,243	1,627	1,891
Other income and gains	98	160	270	197	219
Selling & distribution expenses	12	8	59	0	0
Administrative expenses	(17)	(23)	(41)	(48)	(55)
Other expenses	(181)	(331)	(432)	(545)	(651)
Operating profit	419	694	1,099	1,230	1,404
Net finance costs	(41)	(220)	(398)	(461)	(495)
Share of profit of jce/asso	5	42	(9)	(9)	(9)
Pre-tax profit	383	517	692	760	900
Income tax expense	(65)	(102)	(137)	(151)	(179)
After tax profit	317	414	555	610	722
Minority interest	(32)	(26)	(50)	(55)	(65)
Holders of perpetual instruments	0	0	(85)	(84)	(84)
Net profit	286	388	420	471	573

Balance sheet (RMB m)

As of 31 Dec	2015	2016	2017E	2018E	2019E
Cash and cash equivalents	1,672	4,130	5,346	4,541	4,888
Inventory	21	27	75	87	97
Trade and other receivables	1,197	2,724	2,724	3,818	3,756
Other current assets	35	205	235	255	276
Total current assets	2,924	7,086	8,379	8,701	9,018
Property, plant and equipment	1,617	2,326	3,781	3,760	3,740
Rece. under concession	1,942	2,860	4,531	5,796	7,133
Amounts due for contract works	404	660	804	933	1,054
Other non-current assets	2,715	7,126	6,861	6,612	6,378
Total non-current assets	6,678	12,972	15,977	17,101	18,305
Short term borrowings	1,038	2,609	2,739	2,712	2,685
Trade and other payables	1,074	2,859	3,581	4,128	4,624
Other current liabilities	78	233	261	291	327
Total current liabilities	2,190	5,701	6,581	7,131	7,636
Long term borrowings	2,026	5,690	9,471	9,841	10,231
Other non-current liabilities	443	1,422	1,422	1,422	1,422
Total non-current liabilities	2,469	7,111	10,893	11,263	11,652
Paid in capital	1,193	1,193	1,193	1,193	1,193
Reserves	2,865	3,047	3,349	3,735	4,214
Equity attri. to shareholders	4,058	4,241	4,542	4,928	5,407
MI	884	1,006	1,056	1,111	1,176
Perpetual capital instruments	0	2,000	1,285	1,369	1,453
Total Equity	4,943	7,246	6,882	7,408	8,035

Source: Company data, BOCOM Int'l estimates

Cash flow (RMB m)

Year ended 31 Dec	2015	2016E	2017E	2018E	2019E
Pre-tax profit	383	517	692	760	900
Tax paid	(80)	(63)	(110)	(121)	(143)
Dep'n and amortization	74	210	362	411	395
Change in working capital	(1,175)	(1,683)	(1,170)	(1,973)	(932)
Others	(56)	(70)	9	9	9
Cash from operations	(854)	(1,088)	(217)	(913)	229
Capital expenditure	(814)	(1,796)	(1,560)	(150)	(150)
Others	(517)	(1,416)	0	0	0
Cash from investing	(1,332)	(3,212)	(1,560)	(150)	(150)
Proceed from share issuance	1,514	0	0	0	0
Change in borrowings	1,835	6,810	3,112	343	362
Dividend paid	0	(119)	(119)	(84)	(94)
Others	(112)	47	0	0	0
Cash from financing	3,237	6,738	2,992	259	268
FX change	8	21	0	0	0
Net change in cash	1,059	2,458	1,216	(804)	347

Financial ratios

Year ended 31 Dec	2015	2016	2017E	2018E	2019E
Gross margin (%)	32.6	30.7	24.4	26.8	27.6
EBIT margin (%)	26.9	24.2	21.6	20.3	20.5
Net margin (%)	18.3	13.5	8.3	7.8	8.4
ROA (%)	3.0	1.9	1.7	1.8	2.1
ROE (%)	7.0	9.2	9.3	9.6	10.6
Net gearing (%)	31.1	85.1	139.7	152.0	138.9
Interest coverage (x)	10.2	3.2	2.8	2.7	2.8
Current ratio	1.3	1.2	1.3	1.2	1.2

BOCOM International

 10/F., Man Yee Building, 68 Des Voeux Road Central, Hong Kong

Main: + 852 3766 1899

Fax: + 852 2107 4662

www.bocomgroup.com

Rating System

Analyst Stock Ratings:

Buy: The stock's total return is expected to **exceed** that of the corresponding industry over the next 12 months.

Neutral: The stock's total return is expected to be **in line with** that of the corresponding industry over the next 12 months.

Sell: The stock's total return is expected to be **below** that of the corresponding industry over the next 12 months.

Not-Rated: The analyst **does not have conviction** regarding the outlook of the stock's total return relative to that of the corresponding industry over the next 12 months.

Trading Buy: The stock's **absolute** return is expected to be **very attractive** in the near term. This rating can be different from the rating with a view over the next 12 months.

Trading Sell: The stock's **absolute** return is expected to be **very unattractive** in the near term. This rating can be different from the rating with a view over the next 12 months.

Analyst Industry Views:

Outperform: The analyst expects the industry coverage universe to be **attractive** relative to the relevant broad market benchmark over the next 12 months.

Market perform: The analyst expects the industry coverage universe to be **in line with** the relevant broad market benchmark over the next 12 months.

Underperform: The analyst expects the industry coverage universe to be **unattractive** relative to the relevant broad market benchmark over the next 12 months.

Broad market benchmark for Hong Kong is **the Hang Seng Composite Index**, for China A-shares is the **MSCI China A Index**, for US-listed Chinese companies is **S&P US Listed China 50 (USD) Index**.

Research Team

Head of Research

@bocomgroup.com

Hao HONG, CFA	(852) 3766 1802	hao.hong
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Macro-Strategy

Hao HONG, CFA	(852) 3766 1802	hao.hong
Karen TAN	(852) 3766 1825	karen.tan
Grace HUA, CFA	(852) 3766 1837	grace.hua
Xiao WEN, PhD	(852) 3766 1834	xiao.wen

Banks/ Non-Bank Financials

Li WAN, CFA, FRM	(86) 10 8800 9788 - 8051	wanli
Jaclyn Wang	(86) 21 6065 3681	jaclyn.wang
Hannah HAN	(852) 3766 1858	hannah.han
Jennifer ZHANG	(852) 3766 1850	yufan.zhang

Consumer

Summer WANG, CFA	(852) 3766 1808	summer.wang
------------------	-----------------	-------------

Environmental Services

Wallace CHENG	(852) 3766 1810	wallace.cheng
---------------	-----------------	---------------

Gaming & Leisure

Alfred LAU, CFA, FRM	(852) 3766 1807	alfred.lau
----------------------	-----------------	------------

Healthcare

Lilian WAN	(852) 3766 1849	lilian.wan
Grace ZHAO	(86) 21 6065 3611	grace.zhao

Deputy Head of Research

@bocomgroup.com

Geoffrey CHENG, CFA	(852) 3766 1809	geoffrey.cheng
---------------------	-----------------	----------------

Internet

Yuan MA, PhD	(86) 10 8800 9788 - 8039	yuan.ma
Connie GU, CPA	(86) 10 8800 9788 - 8045	connie.gu
Mengqi SUN	(86) 10 8800 9788 - 8048	mengqi.sun
Zhe ZHOU	(86) 10 8800 9788 - 8041	zhe.zhou
Shan Ying	(86) 10 8800 9788 - 8044	ying.shan

Property

Alfred LAU, CFA, FRM	(852) 3766 1807	alfred.lau
Philip TSE, CFA, FRM	(852) 3766 1815	philip.tse
Carmen WONG	(852) 3766 1830	carmen.wong

Renewable Energy

Louis SUN	(86) 21 6065 3606	louis.sun
-----------	-------------------	-----------

Technology

Chris YIM	(852) 3766 1803	christopher.yim
-----------	-----------------	-----------------

Transportation & Industrials

Geoffrey CHENG, CFA	(852) 3766 1809	geoffrey.cheng
Fay ZHOU	(852) 3766 1816	fay.zhou
Luya YOU	(852) 3766 1836	luya.you

Automobile & Defense

Angus CHAN	(86) 21 6065 3601	angus.chan
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