

Last Closing: HK\$ 3.18

Upside: +6%

Target Price: HK\$ 3.38↓

Environmental Sector

Yunnan Water (6839.HK)

Cloudy outlook in the short term

UP MP OP

Financial Highlights

Y/E 31 Dec	2015	2016	2017E	2018E	2019E
Revenue (RMB m)	1,558	2,866	4,863	4,944	5,696
YoY growth (%)	41.6	83.9	69.7	1.7	15.2
Net profit (RMB m)	286	388	381	395	510
EPS (RMB)	0.240	0.325	0.319	0.331	0.427
EPS growth (%)	24.1	35.8	-1.9	3.8	29.1
P/E (x)	11.5	8.5	8.6	8.3	6.4
BVPS (RMB)	3.40	3.55	3.77	4.04	4.40
P/B (x)	0.8	0.8	0.7	0.7	0.6
Dividend yield (%)	3.6	3.6	2.3	2.4	3.1

Source: Company, BOCOM Int'l estimates

- 1H17 earnings dragged by lower construction revenue recognition and mediocre project operation:** 1H17 net profit came in at Rmb92m, up 14.4% YoY. However, stripping off one-off items of Rmb154m, pretax profit should be Rmb32m in 1H17 (vs Rmb107m in 1H16). As always, YNW's earnings seasonality which is largely skewed to the second half (e.g. 2:8 split in 1H16:2H16 net profit) could be blamed for such swing in earnings. However, we also saw: (i) deteriorating GPM across the board (except for the solid waste segment) due to slow ramp-up of new projects and weak recovery of profitability of GNS projects (which still recorded gross loss of ~Rmb10m in total); and (ii) low degree of recognition of EPC and PPP construction revenue in 1H17 according to auditor's opinion. As a result, overall GPM declined to 24.9% in 1H17 (vs 32.0% in 1H16). Revenue from construction and sales of equipment of Rmb178m only reached 32% of our original forecast in 1H17.
- Struggling amid skyrocketing financing cost.** Financing cost surged 241% YoY to Rmb216m in 1H17. Coupled with the Rmb43m interest cost from perpetual instruments, total financing cost was 28% ahead of our estimate. By 1H17, YNW's net gearing reached a whopping level of 210% (excluding perpetual instruments), compared with 85% by the end of 2016. Facing the hefty financing pressure, management indicated they will be more selective on new projects. Meanwhile, management is considering several ways to lessen financing burden, such as formation of investment fund for new projects and capital injection from parent company Yunnan Metropolitan Construction Investment. Nevertheless, there is no concrete timetable for such plans.
- Further cut on earnings forecast to factor in weaker operational side and higher financing cost.** We cut our 2017-19E net profit forecast by 9.0%/16.2%/8.6%, respectively. We now forecast a slight drop in 2017E net profit to Rmb381m, followed by 3.8%/29.1% YoY growth in net profit during 2018-19E due to slight improvement in GPM and faster recognition of construction revenue from PPP projects. Meanwhile, we forecast net gearing to stay high at 145% by the end of 2017E. We expect the company could trim its short-term borrowings and retain most of the long-term borrowings to fund current project development.
- Downgrade to Neutral on weaker earnings visibility; capital injection from parent a potential +ve catalyst:** We maintain our valuation benchmark of 8.8x 2018E P/E, which is 1 S.D. below historical average forward P/E. Our target price is lowered to HK\$3.38 (from HK\$4.00) after our adjustment in EPS forecast. We change our rating from Buy to Neutral in light of a more conservative stance on the company's earnings visibility and quality. In our view, YNW's efforts in lowering net gearing level and improving project operation would be essential for reaccelerating earnings growth ahead. Moreover, we view the proposed capital injection from parent company as a potential positive catalyst to the company.



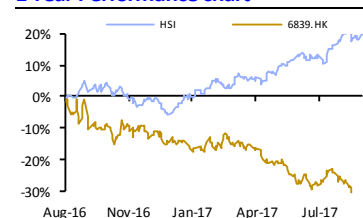
- Skyrocketing financing cost, lower construction revenue recognition and mediocre project operation were the key reasons for weak 1H17 results.
- We cut 17E/18E earnings forecast by ~9%/16%. Net gearing is expected to stay high at 145% by the end of 2017.
- Our TP is trimmed to HK\$3.38. Rating is changed from Buy to Neutral.

Stock data

52w High (HK\$)	4.78
52w Low (HK\$)	3.14
Market cap (HK\$ m)	3,794
Issued shares (m)	1,193
Avg daily vol (m)	0.99
1-mth change (%)	-8.36
YTD change (%)	-21.87
50d MA (HK\$)	3.43
200d MA (HK\$)	3.84
14-day RSI	34.0

Source: Company data, Bloomberg

1 Year Performance chart



Source: Company data, Bloomberg

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

Figure 1: 1H17 results highlight

(RMB m)	1H16	2H16	1H17	1H17E	YoY Change (%)	Deviation (%)
Revenue	868	1,998	1,658	1,807	91.0	-8.3
Cost of sales	(590)	(1,396)	(1,245)	(1,344)	110.9	-7.4
Gross profit	278	602	413	463	48.9	-10.8
Other income	44	116	155	51	248.5	204.5
Other gains	4	5	59	5	1,583.8	1,038.7
Selling expenses	(13)	(10)	(18)	(23)	38.4	-20.5
Administrative expenses	(142)	(189)	(203)	(184)	42.3	10.3
Operating profit	170	524	407	313	139.3	30.1
Finance costs - net	(63)	(157)	(216)	(202)	241.2	7.0
Share of p/l of asso and jce	(0)	42	(4)	2	7,582.5	-319.0
Profit before income tax	107	410	186	113	74.7	65.3
Income tax expenses	(17)	(85)	(31)	(22)	77.4	37.7
Profit for the year	89	325	156	90	74.2	72.2
MI	(9)	(17)	(21)	(9)	132.5	128.2
Holders of perpetual instruments			(43)	0	NA	NA
Net profit	80	308	92	81	14.4	13.2
GPM (%)	32.0	30.1	24.9	25.6		
OPM (%)	19.6	26.2	24.5	17.3		
NPM (%)	9.2	15.4	5.5	4.5		

Source: Company data, BOCOM Int'l

Figure 2: Revenue and gross profit breakdown

(RMB m)	1H16	2H16	1H17	YoY Change (%)
Revenue				
Wastewater treatment	252	376	597	136.6
Water supply	309	330	620	100.5
Solid waste	109	317	238	119.8
EPC & equipment sales	166	944	178	7.3
O&M	32	32	24	-23.5
Total	868	1,998	1,658	91.0
Gross profit				
Wastewater treatment	128	190	220	71.2
Water supply	70	49	66	-6.1
Solid waste	31	57	96	207.6
EPC & equipment sales	38	292	28	-26.8
O&M	10	14	4	-63.7
Total	278	602	413	48.9
Gross margin (%)				
Wastewater treatment	50.8	50.4	36.8	
Water supply	22.7	15.0	10.6	
Solid waste	28.9	18.0	40.4	
EPC & equipment sales	22.9	30.9	15.6	
O&M	31.1	43.5	14.8	
Overall gross margin	32.0	30.1	24.9	

Source: Company data, BOCOM Int'l

Figure 3: Revenue and gross profit forecast

Y/E 31 Dec (RMB m)	2015	2016	2017E	2018E	2019E
Revenue					
Wastewater treatment	420	628	1,061	893	873
Water supply	455	639	1,368	710	658
Solid waste	8	425	594	727	897
EPC & equipment sales	597	1,110	1,779	2,552	3,206
O&M	79	63	62	62	62
Total	1,558	2,866	4,863	4,944	5,696
Gross profit					
Wastewater treatment	208	318	401	476	549
Water supply	109	120	222	185	203
Solid waste	1	88	221	253	296
EPC & equipment sales	144	330	319	458	576
O&M	46	24	10	10	10
Total	508	880	1,173	1,382	1,633
Gross margin (%)					
Wastewater treatment	49.4	50.6	37.8	53.3	62.9
Water supply	23.9	18.7	16.2	26.1	30.8
Solid waste	15.5	20.8	37.2	34.8	33.0
EPC & equipment sales	24.2	29.7	17.9	17.9	18.0
O&M	58.3	37.3	16.0	16.0	16.0
Overall gross margin	32.6	30.7	24.1	27.9	28.7

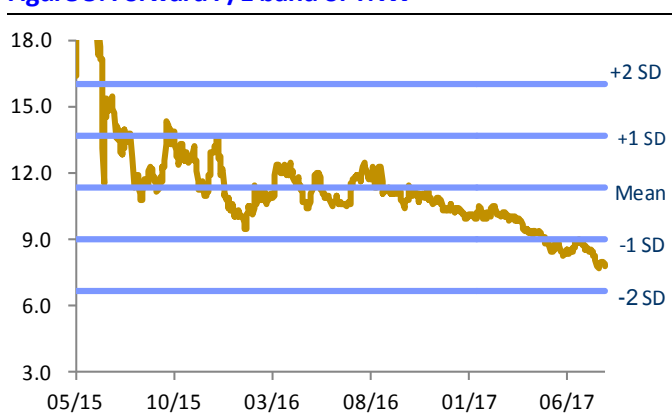
Source: Company data, BOCOM Int'l

Figure 4: Change in forecast

	Old forecast			New forecast			Change (%)		
	2017E	2018E	2019E	2017E	2018E	2019E	2017E	2018E	2019E
Revenue (RMB m)	4,991	5,042	5,555	4,863	4,944	5,696	-2.6	-1.9	2.5
Net profit (RMB m)	418	471	558	381	395	510	-9.0	-16.2	-8.6
EPS (RMB)	0.35	0.395	0.468	0.319	0.331	0.427	-9.0	-16.2	-8.6

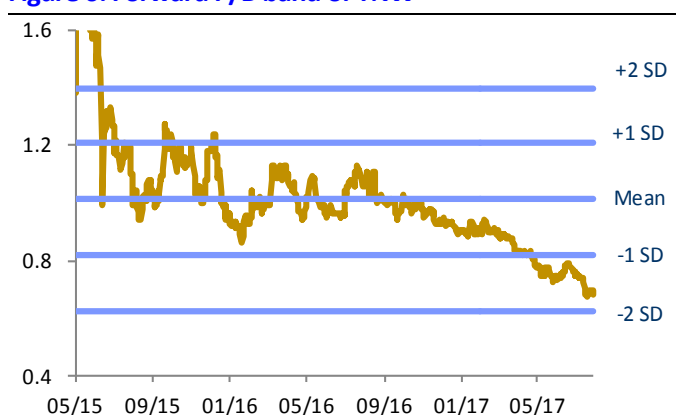
Source: BOCOM Int'l estimates

Figure 5: Forward P/E band of YNW



Source: Bloomberg, BOCOM Int'l

Figure 6: 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	893	873
Water supply	455	639	1,368	710	658
EPC & equip sales	597	1,110	1,779	2,552	3,206
O&M	79	63	62	62	62
Solid waste	8	425	594	727	897
Turnover	1,558	2,866	4,863	4,944	5,696
COGS	(1,051)	(1,986)	(3,690)	(3,562)	(4,063)
Gross profit	508	880	1,173	1,382	1,633
Other income and gains	98	160	264	197	219
Selling & distribution expenses	12	8	59	12	12
Administrative expenses	(17)	(23)	(39)	(40)	(46)
Other expenses	(181)	(331)	(413)	(445)	(541)
Operating profit	419	694	1,044	1,107	1,277
Net finance costs	(41)	(220)	(398)	(442)	(455)
Share of profit of jce/asso	5	42	(9)	(9)	(9)
Pre-tax profit	383	517	638	656	814
Income tax expense	(65)	(102)	(126)	(130)	(161)
After tax profit	317	414	511	526	653
Minority interest	(32)	(26)	(46)	(47)	(59)
Holders of perpetual instruments	0	0	(85)	(84)	(84)
Net profit	286	388	381	395	510

Balance sheet (RMB m)

Year ended 31 Dec	2015	2016	2017E	2018E	2019E
Cash and cash equivalents	1,672	4,130	5,174	4,347	4,558
Inventory	21	27	72	70	80
Trade and other receivables	1,197	2,724	2,724	3,115	3,121
Other current assets	35	205	235	255	276
Total current assets	2,924	7,086	8,205	7,787	8,034
Property, plant and equipment	1,617	2,326	3,781	3,760	3,740
Rece. under concession	1,942	2,860	4,516	5,774	7,094
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	15,962	17,079	18,266
Short term borrowings	1,038	2,609	2,739	2,712	2,685
Trade and other payables	1,074	2,859	3,438	3,318	3,785
Other current liabilities	78	233	259	285	317
Total current liabilities	2,190	5,701	6,436	6,315	6,787
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	3,309	3,627	4,058
Equity attri. to shareholders	4,058	4,241	4,502	4,821	5,251
MI	884	1,006	1,052	1,099	1,158
Perpetual capital instruments	0	2,000	1,285	1,369	1,453
Total Equity	4,943	7,246	6,838	7,289	7,862

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	638	656	814
Tax paid	(80)	(63)	(101)	(104)	(129)
Dep'n and amortization	74	210	362	411	395
Change in working capital	(1,175)	(1,683)	(1,296)	(1,916)	(1,011)
Others	(56)	(70)	9	9	9
Cash from operations	(854)	(1,088)	(389)	(944)	78
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)	(76)	(79)
Others	(112)	47	0	0	0
Cash from financing	3,237	6,738	2,992	267	283
FX change	8	21	0	0	0
Net change in cash	1,059	2,458	1,044	(827)	211

Financial ratios

Year ended 31 Dec	2015	2016	2017E	2018E	2019E
Gross margin (%)	32.6	30.7	24.1	27.9	28.7
EBIT margin (%)	26.9	24.2	21.5	22.4	22.4
Net margin (%)	18.3	13.5	7.8	8.0	9.0
ROA (%)	3.0	1.9	1.6	1.6	1.9
ROE (%)	7.0	9.2	8.5	8.2	9.7
Net gearing (%)	31.1	85.1	144.8	159.5	149.3
Interest coverage (x)	10.2	3.2	2.6	2.5	2.8
Current ratio	1.3	1.2	1.3	1.2	1.2

BOCOM International
 Unit 1701, 17/F, Low Block, Grand Millennium Plaza, 181 Queen's Road Central, Hong Kong

Main: + 852 2297 9888

Fax: + 852 2766 3183

www.bocomgroup.com
Rating System
Company Rating

Buy: Expect more than 20% upside in 12 months

LT Buy: Expect more than 20% upside but longer than 12 months

Neutral: Expect low volatility

Sell: Expect more than 20% downside in 12 months

Sector Rating

Outperform ("OP"): Expect more than 10% upside in 12 months

Market perform ("MP"): Expect low volatility

Underperform ("UP"): Expect more than 10% downside in 12 months

Research Team
Head of Research

@bocomgroup.com

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

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

Banks/ Non-Bank Financials
Shanshan LI, CFA (86) 10 8800 9788 - 8058 lishanshan

Li WAN, CFA, FRM (86) 10 8800 9788 - 8051 wanli

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
David LI (852) 3766 1811 david.li

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

Automobile & Defense
Angus CHAN (86) 21 6065 3601 angus.chan

Analyst Certification

The authors of this report, hereby declare that: (i) all of the views expressed in this report accurately reflect their personal views about any and all of the subject securities or issuers; and (ii) no part of any of their compensation was, is, or will be directly or indirectly related to the specific recommendations or views expressed in this report; (iii) no insider information/ non-public price-sensitive information in relation to the subject securities or issuers which may influence the recommendations were being received by the authors.

The authors of this report further confirm that (i) neither they nor their respective associates (as defined in the Code of Conduct issued by the Hong Kong Securities and Futures Commission) have dealt in or traded in the stock(s) covered in this research report within 30 calendar days prior to the date of issue of the report; (ii) neither they nor their respective associates serve as an officer of any of the Hong Kong listed companies covered in this report; and (iii) neither they nor their respective associates have any financial interests in the stock(s) covered in this report except for one coverage analyst who is holding shares of Shimao Property Holdings Limited.

Disclosure of relevant business relationships

BOCOM International Securities Limited, and/or its associated companies, has investment banking relationship with Bank of Communications, Guolian Securities Co. Ltd., Bank of Zhengzhou Co. Ltd., Human Health Holdings Limited, COFCO Meat Holdings Limited, Hebei Yichen Industrial Group Corporation Limited, China Aircraft Leasing Group Holdings Limited, Orient Securities Company Limited, Wuxi Construction and Development Investment Co., China Development Bank Financial Leasing Co., Ltd, Phoenix Healthcare Group ,Co. Ltd, Everbright Securities Company Limited, China First Capital Group Limited, Jiayuan International Group Limited, Luzhou Xinglu Water (Group) Co., Ltd., Postal Savings Bank of China Co., Ltd., China Merchants Securities Co., Limited, Shandong International Trust Co., Ltd, Guangdong Kanghua Healthcare Co., Ltd, CSC Financial Co., Ltd, BOCOM International Holdings Company Limited, HPC Holdings Limited, Guotai Junan Securities Co., Ltd and Zhongyuan Bank Co., Ltd within the preceding 12 months.

BOCOM International Global Investment Limited currently holds more than 1% of the equity securities of Orient Securities Company Limited.

BOCOM International Global Investment Limited currently holds more than 1% of the equity securities of Everbright Securities Company Limited.

BOCOM International Global Investment Limited currently holds more than 1% of the equity securities of Guolian Securities Co., Ltd.

BOCOM International Global Investment Limited currently holds more than 1% of the equity securities of Guotai Junan Securities Co., Ltd.

BOCOM International Prosperity Investment Limited currently holds more than 1% of the equity securities of China YuHua Education Corporation Ltd.

Disclaimer

By accepting this report (which includes any attachment hereto), the recipient hereof represents and warrants that he is entitled to receive such report in accordance with the restrictions set forth below and agrees to be bound by the limitations contained herein. Any failure to comply with these limitations may constitute a violation of law.

This report is strictly confidential and is for private circulation only to clients of BOCOM International Securities Ltd. This report is being supplied to you strictly on the basis that it will remain confidential. No part of this report may be (i) copied, photocopied, duplicated, stored or reproduced in any form by any means or (ii) redistributed or passed on, directly or indirectly, to any other person in whole or in part, for any purpose without the prior written consent of BOCOM International Securities Ltd.

BOCOM International Securities Ltd, its affiliates and related companies, their directors, associates, connected parties and/or employees may own or have positions in securities of the company(ies) covered in this report or any securities related thereto and may from time to time add to or dispose of, or may be interested in, any such securities. Further, BOCOM International Securities Ltd, its affiliates and its related companies may do and seek to do business with the company(ies) covered in this report and may from time to time act as market maker or have assumed an underwriting commitment in securities of such company(ies), may sell them to or buy them from customers on a principal basis and may also perform or seek to perform investment banking, advisory, underwriting, financing or other services for or relating to such company(ies) as well as solicit such investment, advisory, financing or other services from any entity mentioned in this report. In reviewing this report, an investor should be aware that any or all of the foregoing, among other things, may give rise to real or potential conflicts of interest.

The information contained in this report is prepared from data and sources believed to be correct and reliable at the time of issue of this report. This report does not purport to contain all the information that a prospective investor may require and may be subject to late delivery, interruption and interception. BOCOM International Securities Ltd does not make any guarantee, representation or warranty, express or implied, as to the adequacy, accuracy, completeness, reliability or fairness of any such information and opinion contained in this report and accordingly, neither BOCOM International Securities Ltd nor any of its affiliates nor its related persons shall be liable in any manner whatsoever for any consequences (including but not limited to any direct, indirect or consequential losses, loss of profits and damages) of any reliance thereon or usage thereof.

This report is general in nature and has been prepared for information purposes only. It is intended for circulation amongst BOCOM International Securities Ltd's clients generally and does not have regard to the specific investment objectives, financial situation and the particular needs of any specific person who may receive this report. The information and opinions in this report are not and should not be construed or considered as an offer, recommendation or solicitation to buy or sell the subject securities, related investments or other financial instruments thereof.

The views, recommendations, advice and opinions in this report may not necessarily reflect those of BOCOM International Securities Ltd or any of its affiliates, and are subject to change without notice. BOCOM International Securities Ltd has no obligation to update its opinion or the information in this report.

Investors are advised to make their own independent evaluation of the information contained in this research report, consider their own individual investment objectives, financial situation and particular needs and consult their own professional and financial advisers as to the legal, business, financial, tax and other aspects before participating in any transaction in respect of the securities of company(ies) covered in this report. The securities of such company(ies) may not be eligible for sale in all jurisdictions or to all categories of investors.

This report is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction where such distribution, publication, availability or use would be contrary to any law, regulation, rule or other registration or licensing requirement.

BOCOM International Securities Ltd is a subsidiary of Bank of Communications Co Ltd.