

Big splash

by Leu Siew Ying

Sembcorp Industries and Boustead are moving into China's water business, while players like Hyflux and Bio-Treat are repositioning to stay in the game. Is a new crop of leaders emerging in the sector?

Sembcorp Industries was greeted with a spirited rebuff from Cascal's board, complete with threats of legal action, when it made its initial overture towards the US-listed water company in April. With Cascal's controlling shareholder Biwater Investment determined to sell, however, the takeover was inevitable. In fact, Biwater had reportedly approached some 50 potential investors before striking a deal with Sembcorp. Earlier this month, Cascal was delisted from the New York Stock Exchange with barely a squeak.

For Sembcorp, the deal is an opportunity to take its burgeoning water business global. Since 1997, the company has been building and acquiring water and wastewater plants in Singapore, China, the UK and the Middle East. With the acquisition of Cascal, which cost it more than US\$203 million, Sembcorp now has a significant municipal water business and a geographical footprint that extends to countries like Antigua, Chile, Panama, the Philippines, South Africa and Indonesia. Cascal has also tripled Sembcorp's water treatment capacity in China to 1.2 million tonnes a day, up from more than 400,000 tonnes.

For the cluster of water stocks listed in Singapore, the deal is perhaps the most potent symbol yet of the consolidation that is taking place across the industry and the emergence of a new crop of sector leaders. Companies like Bio-Treat Technology, Asia Water Technology and Asia Environment Holdings that once raced to expand their water treatment capacity in China have spent the last couple of years struggling to restructure their balance sheets and raise fresh capital. That is creating an opportunity for other companies to expand on the cheap. For instance, **Boustead Singapore** is paying \$42.7 million to buy a 20% stake in Bio-Treat, which has a capacity of some 955,000 tonnes a day in China.

Earlier this year, a unit of Hong Kong-listed Shanghai Industrial Holdings paid US\$33.5 million (\$45.3 million) for a 75.5% stake in Asia Water Technology, which has a capacity of some 940,000 tonnes a day.

More recently, Japanese trading giant Mitsui said it would team up with Hyflux to buy out the latter's Singapore-listed water trust. Hyflux had expanded aggressively in China over the past decade and created Hyflux Water Trust in 2007 to hold its maturing water plants. But the trust failed to get a sufficiently high market valuation to be an effective securitisation vehicle for Hyflux. Now, armed with cash from Mitsui, Hyflux is trying to expand in China once more. Meanwhile, other companies like Sound Global and United Envirotech that once focused on peripheral activities like engineering, construction and procurement (EPC) contracts that require little capital are now trying to raise debt and build up a portfolio of water plants that generate steady earnings.

Will this new wave of investors in China's water sector fare any better than the previous wave? What mistakes were made? Are they likely to be repeated? And, how should investors position themselves?

Fast growth, low margins

Analysts say the growth potential of China's water sector is stronger than ever. By some estimates, China still properly treats only about 75% of its wastewater. On top of that, the government has become conscious of environmental protection issues in recent years, says Evan Li, an analyst at Standard Chartered. The result is accelerated spending on sewerage and wastewater treatment facilities.

China's government earmarked some RMB470 billion (\$93.5 billion) for sewage treatment and RMB310 billion for water supply facilities in the 11th Five Year Plan (2006 to 2010), according to a report by Ernst & Young that was prepared for Sound Global's now-delayed dual-listing in Hong Kong. The government has since allocated an additional RMB210 million

for environmental protection projects. Further spending programmes in the environmental protection field are likely in the years ahead, analysts say.

However, water tariffs in China do not reflect the company's water scarcity and the actual cost of operating treatment facilities, the Ernst & Young report says. In a 2009 survey, Global Water Intelligence found that China's water tariff is only 20% of the world's average. From 2003 to 2008, the compound annual growth rate of tariffs in 36 major cities was only 6%. In 2009, however, many major cities like Beijing took advantage of a severe drought to raise water tariffs by a much faster rate.

At the same time, many water plants in China rely on relatively rudimentary, low-cost technology. That leaves water companies with little room to augment the overall profitability of their investment in water projects with EPC work. Notably, while Hyflux likes to burnish its membrane filtration technology credentials and experience in desalination projects, the plants held under its Hyflux Water Trust were mostly wastewater treatment facilities at the bottom of the value chain.

Cascal's results for FY2010 to March provide an indication of how growth rates and margins are sharply different in China versus more developed markets. In the UK, Cascal's water plants serve 420,000 people and collected revenue of US\$81.2 million, an increase of 3.7% y-o-y. On the other hand, its revenue in China, where its plants serve 1.86 million people was only US\$31.6 million, but its growth rate in China was 50%. In terms of Ebitda (earnings before interest, taxes, depreciation and amortisation), the UK chalked up US\$34.3 million and China reported just US\$6.1 million.

Shakeout underway

Besides the relatively low tariffs in China, a number of other changes took place in its water sector over the past decade that increased the risk for players. Keith Chu, vice-president for corporate marketing and investor relations at **Boustead**, says water projects in the 1990s were essentially just engineering deals awarded mostly by institutions like the World Bank and Asia Development Bank, which paid promptly and in US dollars. In fact, **Boustead's** water engineering unit Salcon, which it acquired in 2002, was a major player in the sector in those early days. Among other things, it participated in the building of a one-million-tonne-a-day municipal wastewater treatment plant in Shanghai. Chu says, adding: "We completed more than 70 projects,

mostly municipal wastewater treatment plants."

As China opened up, however, the contracts were awarded by Chinese agencies and denominated in renminbi. Over time, China began moving towards build-operate-transfer (BOT) projects, for which water companies needed more capital to participate. Meanwhile, competition intensified as more and more small companies with limited experience piled into the sector. **Boustead** opted to stay out the game as it changed, Chu says, and it was relegated to a small presence in Tianjin and Shanghai.

Now, things are changing once more and **Boustead** sees an emerging opportunity to get back into the water market it has largely ignored for years. Many small companies that got into the business have run into financial problems in the wake of the financial crisis. In the Singapore market alone, at least three water companies have faced difficulty in refinancing their debt over the last few years and have resorted to drastic restructuring exercises. Even relatively successful players like Hyflux are repositioning themselves and adjusting their strategies in China.

"A lot of the weaker players will be weeded out," Chu says. "We are biding our time. With our small presence, we are waiting for the moment of consolidation. One day, the government will have to crack down. There are so many companies operating in China with no track record that would not be able to pass quality requirements."

Boustead's purchase of a 20% stake in Bio-Treat could just be its first step back into the China market. But Chu says the company is alert to new risks in China that might have emerged over the last few years. For one thing, most of the opportunities to build and own water plants in China are now in its second-and third tier cities, where Chu fears the returns will not be as good as those in first-tier cities like Beijing, Shanghai, Guangzhou and Shenzhen. Water players also have to carefully judge the ability of smaller municipalities to pay for the plants and infrastructure they build. "BOT has to be about returns," says Chu. "If they are not up to our expectations, then it's something we can't go into."

Big market that's getting bigger

Chu does not expect China's water industry to become significantly more profitable overnight, though. Even as the weaker players are bought out or fold, more water companies are jumping into the fray, raising money and

trying to grow, eager for a piece of China's fast-growing water industry. That is resulting in conflicting signals from the sector. While Chinese government statistics show that nearly half of municipal water supply companies and more than one-quarter of wastewater treatment players are losing money, companies like Chongqing Water Group and Beijing Origin Water Technology have made spectacular trading debuts in China this year, their shares rallying more than 120%.

Sam Ong, deputy CEO at Hyflux, says the size of the water market in China and the pace of its growth make the short-term financial risks worthwhile. Even as Hyflux focused on securing mega-projects in the Middle East and North Africa over the last couple of years, it maintained a presence in China and continued its "capability building" to take advantage of future opportunities, Ong says. Water projects that were put on hold are gradually getting off the ground again, especially in the northeastern, western and inland parts of China, as well as along its coast.

"The five-year China market is good," Ong tells *The Edge Singapore*. "China is going to be such a huge market for a long, long time to come and this digestion and delay is actually good for our projects because there is no worry about credit risks or plant utilisation." Over time, Ong sees China moving towards more sophisticated water-treatment facilities. That's when Hyflux will really come into its own and flex its edge in membrane filtration and desalination technology. Until then, the company will stay in the game by taking whatever projects that come its way as long as they are profitable, Ong says. "[We are] very open – whether it is water, wastewater, water recycling or desalination projects."

The key challenge for companies like Hyflux is raising money for its projects. As a foreign company, it has not been able to borrow in China to finance its projects there. And its effort to harness investment flows into the water sector through its Hyflux Water Trust proved ineffective. Its tie-up with Mitsui could be a game changer, though. Hyflux is folding its water trust as well as four other water plants into a joint-venture company that will be partly owned by Mitsui. The two partners plan to use the JV company to make further investments in China. "Growth of existing assets as well as opportunities from new projects would be expected on a mid- to long-term basis," says Mikako Sachigai, a spokeswoman for Mitsui.

For Mitsui, the deal is a means of venturing into China with a reliable strategic partner that needs its cash. On the other hand, Hyflux gets

the funding it needs to maintain its presence in China even as a host of small Chinese companies avails themselves of local credit to take on projects. Li of Standard Chartered says it is unlikely China's domestic water players would have needed a foreign partner like Mitsui as they are not short of capital.

Going for scale

To survive against this backdrop, water players in China need to be big or have the ability to quickly become big, says Li. That's because big water players with a large number of cash generating assets will be in the best position to take on more projects and grow. Similarly, a smaller player that has the financial backing of a large parent company will also be able to pick up water deals and quickly scale up.

"The main upside volume growth," says Li. "There are a lot of projects, but it's a matter of whether [the water players] can get them at a fair price. China's wastewater treatment penetration is low at 75% compared with 90% in developed countries, so I don't see any overcapacity in the next three to four years." Even though China's water tariffs are low, companies can make money if they manage their projects carefully and avoid cost overruns, he adds. The ones that succeed can look forward to decent, stable returns.

So, which water companies fit the bill? When looking for the best plays in China, it is hard to avoid the country's home-grown giants. The biggest water company listed in China at the moment is Chongqing Water Group. The company, in which French water company Suez Environnement has a minority stake, has a water and wastewater treatment capacity of more than three million tonnes and a market capitalisation of RMB39 billion. In Hong Kong, there are the likes of Beijing Enterprises Water, which is projected to have a capacity of six million tonnes a day in China by end FY2010 and currently has a market capitalisation of HK\$9.4 billion (\$1.6 billion).

In the Singapore market, Sembcorp bears watching, following its purchase of Cascad. It is unclear for now whether the deal will eventually pay off for Sembcorp, but it certainly has pushed it up the global water league table. It currently has about six million tonnes of capacity across the world, which is about what Beijing Enterprises Water has in China. Then, there are mid-sized companies like **Boustead**, which probably has the financial muscle and know-how to build up a good-sized water business in China.

Investors with the stomach for more risk might prefer to bet on Bio-Treat, in which **Boustead**

itself is investing. Bio-Treat reached an agreement with a Chinese investment company, Giant Delight, last December for a deal that will inject \$70.6 million to repair its balance sheet. The money, to be raised through a combination of cash and the issue of new shares and warrants, will go to paying its convertible-bond holders and other creditors. In June, Giant Delight brought in **Boustead** to help with the restructuring.

In a similar vein, Asia Environment Holdings is in the midst of raising funds to repay loans amounting to some RMB640 million. With a capacity of 1.5 million tonnes a day, it is among the last of the sizeable but troubled China water stocks listed in Singapore to

restructure its balance sheet. The company's difficulties stem from getting financial investors to fund its projects but these investors subsequently declined to put up additional capital when some of the projects hit unexpected cost overruns. Asia Environment had to fund these additional costs on its own, straining its financial resources. The company is now weighing several options, including tapping equity or selling its minority stakes in some of the plants, to pay off its debts.

If China does not lose its thirst for water or its focus on environmental issues, a second wave of investment in its water and wastewater treatment sector could now be building up.

Riding on water stocks

COMPANY	MARKET CAP (\$ MIL)	SHARE PRICE AS AT AUG 19 (\$)	TREATMENT CAPACITY IN CHINA (TONNES)
Asia Environment Holdings	66.38	0.155	1.5 mil
Asia Water Technology	143.20	0.065	940,000
Bio-Treat Technology	74.30	0.080	955,000
Boustead Singapore	460.00	0.890	-
Hyflux	1,776.00	3.110	665,000
Sembcorp Industries	7,569.00	4.240	1.2 mil
Sound Global	993.00	0.770	1.25 mil
United Envirotech	168.00	0.385	305,000