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HanKore taps connected financiers while China puts higher priority on water sector

by ***Leu Siew Ying***

Chen Da Wei, chairman and CEO of HanKore Environment Tech, might have been displaying uncanny prescience when he told *The Edge Singapore* in June that China's water industry was on the brink of 10 golden years. The following month, the Chinese Communist Party's Politburo, the highest decision-making body in the country, held its first-ever meeting to discuss water conservancy issues. Following the meeting, water was placed on a list of 10 strategic industries to be promoted. It was also decided that water tariffs would be raised, and that 10% of profits from land sales would be invested in water conservancy projects. Now, China is targeting to double its wastewater treatment capacity to 90 million tonnes a day in its current five-year development plan ending in 2015.

For Chen, this apparent reprioritising of the water-treatment industry by Beijing couldn't have come at a better time. He has just taken control of the troubled Bio-Treat Technology, with the help of several financial backers. And, he has managed to restructure its balance sheet, putting the company in a stronger position to grow. "I can tell you the financial problems are finally resolved. We have plans to make the company a leading environmental-solutions provider focusing on the water sector," he tells *The Edge Singapore*, during a recent interview. "In three years, we want to reach five million tonnes of water-treatment capacity a day. In five years, we want to achieve 10 million tonnes." The company also has plans to broaden its business scope to include water recycling and sludge treatment, he adds.

HanKore currently has the capacity to treat 1.29 million tonnes of wastewater a day, and it has a contracted water and wastewater treatment capacity of 560,000 tonnes. Its financial statements have, however, been flooded with red ink. For the year to June, it reported a 45% fall in revenue to RMB196 million ($37.18 million), and a loss of RMB405.7 million versus a profit of RMB222 million the previous year. Stanley Yeung, chief financial officer at HanKore, says things are turning around though. For one thing, the large loss in the recent financial year was due to some RMB399 million in provisions for impairment losses on the value of its assets as well as for project overruns and repair costs. "We are already profitable without impairment provisions," Yeung says.

In fact, officials at HanKore expect the company's plants to begin generating more income as soon as higher water tariffs are implemented. It has already successfully negotiated a 9% increase in tariffs for its project in Lianyungang, and the chances of increased tariffs at its other plants are good, going by recent adjustments made in several cities. Tariffs in Nanjing were 30% higher last year compared with 2009. They were 29% higher in Jinan, 16% higher in Beijing and 43% higher in Guangzhou. The company is now negotiating for increases at its plants in Xianyang, Kunshan and Suzhou. The water-tariff contracts that are currently being negotiated are said to provide for adjustments for inflation as well as the volume of water treated.

Meanwhile, the company's restructured balance sheet appears to afford it plenty of room to grow, after a long drawn out recapitalisation exercise that included the issue of 1.2 billion shares and 57.7 million warrants to raise $48 million, and a rights issue of 947.6 million shares. Its total borrowings, all of which is project financing, stood at RMB480 million at end-June, giving a debt-to-equity ratio of 33%. "We are in the position to tap the capital markets for further growth," says Yeung. "I believe a reasonable rate should be 50% to 60%." That suggests the company has room to raise up to RMB500 million in additional debt.

At the same time, the company is negotiating with its lenders to reschedule payments to better match its revenue pattern. "We are now looking for 10-year term loans. There is nothing longer than 10 years in China," says Yeung. Company officials are now in talks with policy banks in China and International Finance Corp, and that could result in cheaper and longer-term funds for the company. Water projects are typically financed with debts of up to 70%. The remaining 30% comes from internal funds and supplier credit. In practice, the company only needs to secure 15% of the funds needed to start up its projects.

What does all this mean for shares in HanKore? On the face of it, the stock is beginning to look like a bargain. HanKore has a net asset value (NAV) of RMB1.4 billion, or 6.4 cents per share, after repaying its secured debt and completing the debt restructuring in April. That's 36% more than the current market value of its shares.

New backers

Yet, Hankore isn't the only Chinese water treatment company that is finding its way out of financial trouble. Asia Water Technology and Asia Environment Holdings faced similar problems, financing long-term projects with short-term funds. Asia Water Technology has now restructured its debts in an exercise that led to Hong Kong-listed Shanghai Industrial Holdings taking over the company in February last year. United Envirotech is pre-empting funding problems by bringing in a partner with deep pockets and a long-term view of the industry — Kohlberg Kravis Roberts. Other companies such as Sinomem Technologies and Asia Environment Holdings have chosen to delist from the Singapore Exchange.

What sets HanKore apart from these other players? Why would it perform any better in the future after being entangled in similar financial problems in the past? Will HanKore meet Chen's ambitious growth targets?

The key difference between HanKore and other locally listed water-treatment companies is the apparently well-connected slate of partners Chen has brought together to take a collective 29% stake in the company. Among them is the Suzhou Ventures Group — a state-backed fund manager with more than RMB100 billion in assets under management — with a 2.3% stake; Ancient Jade International Holdings with a 5.39% stake; and **Boustead Singapore** with 2.4%. Chen holds a 19% stake in HanKore.

"I had a lot of discussions with many people. This is a very big investment. I had to be very cautious. Bio-Treat is a foreign company and there are foreign laws involved," he says, when asked about his partners. "In the end, I chose people who could add value to the company." Chen says he first met Lin Xianghong, president of Suzhou Ventures Group, several years ago, during a visit to the China-Singapore Suzhou Industrial Park to exchange views on the water industry. And, he ran into Lin Zheying, chairman of Jade Capital Management, which owns Ancient Jade, during a seminar. He kept in touch with them over the years. When the opportunity to take over Bio-Treat came up, Chen weighed the pros and cons with them, and eventually brought them in as partners.

Zheying, 47, who has been appointed executive director of HanKore, was a division head and, later, deputy director of the department of trade in services at the Commerce Ministry, where he was involved in negotiations to open up China's water market to fulfil conditions for its access to the World Trade Organization. "It is because of my involvement in the formulation of policies to open up and reform the water market in China as well as the implementation of those policies that I see the potential of the water business," says Zheying. "Chen Dawei, Lin Xianghong of Suzhou Ventures Group and I belong in the same circle. So, when he brought us the proposal to restructure Bio-Treat, we decided to join him."

Chen figures that Xianghong is in an equally good position to help HanKore succeed. Xianghong was previously an official at the China-Singapore Suzhou Industrial Park, during which time he came to Singapore for training. Subsequently, he was appointed to set up the venture-capital fund, which made him one of the first fund managers in China. "Suzhou Ventures Capital has good connections with local governments and with [central] government departments. They can help us source market opportunities and capital," says Chen.

Growing investor interest

Another investor that recently came on board is Firstree Group, which bought an 8.17% stake in HanKore from Dongguan Baosheng Environment Investment in July, for $16.9 million, or five cents per share. That was a 39% premium to HanKore's market price at the time. Wang Ting, who owns Hangzhou-based Firstree, says he is confident the investment will pay off. "After 2½ years of restructuring, and with a new management team, I have confidence in the company. I am sure Chen did due diligence before he went in. I believe in the team, their strategy and the direction they are taking," he tells *The Edge Singapore*.

Wang, who is now effectively the second-largest shareholder of HanKore, says he personally visited all of the company's water plants and came away convinced it has the best management, technology and operating scale among similar companies in China. Firstree also owns stakes in two other state-controlled water companies, but Wang figures that HanKore is a superior investment prospect. "The latest financial statement shows its net asset value is higher than the share price, so we find it hard to believe it can be so cheap," he says. "Its share price is really too low."

Even investors who suffered from the massive dilution of HanKore's restructuring exercise are optimistic. Chen Ke, director of China operations at Shah Capital Management, says his firm plans to hold on to its stake for at least five years. "Our strategy is long term. We see value here," he says. "Even though the previous management team did not do a good job, the assets are still there." Chen also points out that Kohlberg Kravis Roberts paid 20 times earnings for its recently acquired 38% stake in United Envirotech. "If you compare United Envirotech and HanKore's assets, you will find that HanKore is a hidden gem for us." Shah Capital Management, a US-based private-equity fund, started investing in Bio-Treat in 2008, but has seen its 13.78% stake dwindle to 4.92%.

Whether all this optimism will prove to be justified depends on Chen achieving the capacity growth he is promising. And, he doesn't have much room to make mistakes. Even with the tariff increases, water treatment assets are not really that lucrative, according to analysts. "The water business is not a very profitable business," says Lei Ming, an analyst at AJ Securities. "The new policies will allow tariffs to rise to make sure that water companies make enough profit to invest in the sector but the increase will be controlled because the government does not want it to contribute to higher inflation. So for water companies to grow, it has to be through volume."

Lei says HanKore's initial target to raise capacity to five million tonnes is achievable, but he is sceptical about its target to double capacity after that. "It would mean that they are growing at above-average rates. I think seven million to eight million tonnes is more realistic," he says.

Whatever the case, Chen isn't wasting any time positioning his company for growth. HanKore is already adding capacity to some of its plants. For instance, it is preparing to begin construction on the second phase of its plant at Xianyang, in Shaanxi province. And, there could be more projects in the area soon. In July, HanKore signed a five-year strategic cooperation agreement with the authorities in Xianyang that gives HanKore right of first refusal to projects with an aggregate value of RMB1 billion within a five-year period. Xianyang, together with the historic city of Xi'an, where the terracotta warriors were discovered, are within a new economic zone that has been created to drive growth in China's inland provinces.

It looks like HanKore's new controlling shareholder, and his partners, are off to a good start.