

INDEPTH UPDATE REPORT

Date: 10-March 2011

Name of PLC: <i>Salcon Berhad</i>	Target Price:	RM 0.75
Business Summary : <i>Investment holding company involved in water and wastewater treatment, raw water transfer via concession and O&M contract, as well as water construction</i>		
Major Shareholders :		
<i>Dato' Seri Goh Eng Toon</i>		14.3%
<i>Dato' Tee Tiam Lee</i>		11.9%
<i>(as at 30 Apr 2010)</i>		
PLC Website : <i>www.salcon.com.my</i>	Recommendation:	Buy
IR Contact : <i>Ms Chern Meng Gaik</i> mgchern@salcon.com.my	Market Capitalisation:	RM 293.6m
<ul style="list-style-type: none"> - <i>FBM Small Cap</i> - <i>FBM Emas Shariah</i> 	Current Price :	RM 0.62
	Market / Sector:	Trading/Services
	Stock Code:	8567
Analyst : <i>Lim Boon Ngee</i> <i>Tel : +603 2163 3200; Email : bnlim@nra.com.my</i>		

Key Stock Statistics	2009	2010	2011F	2012F
EPS (sen)	4.7	4.5	4.5	5.5
P/E (x)	13.1	13.8	13.9	11.4
Dividend/Share (sen)	1.5	1.5	1.5	1.5
NTA/Share (RM)	0.63	0.62	0.78	0.82
Book Value/Share (RM)	0.66	0.65	0.81	0.85
Issued Capital (mil shares)	467.7	473.5	473.5	473.5
52-weeks Share Price Range (RM)		0.585 - 0.89		

Per Share Data	2009	2010	2011F	2012F
Book Value (RM)	0.66	0.65	0.81	0.85
Operating Cash Flow (sen)	9.3	1.4	12.1	5.4
Earnings (sen)	4.7	4.5	4.5	5.5
Dividend (sen)	1.5	1.5	1.5	1.5
Payout Ratio (%)	31.8	33.4	33.7	27.5
PER (x)	13.1	13.8	13.9	11.4
P/Cash Flow (x)	6.7	45.7	5.1	11.5
P/Book Value (x)	0.9	0.9	0.8	0.7
Dividend Yield (%)	2.4	2.4	2.4	2.4
ROE (%)	7.4	6.9	6.1	6.6
Net Gearing (%)	n.c.	29.4	n.c.	n.c.

n.c. - net cash

P&L Analysis (RM mil)	2009	2010	2011F	2012F
Revenue	369.9	418.2	404.0	479.7
Operating Profit	33.6	31.5	41.1	50.3
Depreciation	(10.7)	(14.9)	(18.8)	(20.1)
Finance, net	(4.0)	(3.8)	(2.8)	(1.6)
Associate	3.8	3.6	4.0	4.0
EI	-	5.9	-	-
Pre-tax Profit	33.5	37.2	42.3	52.7
Effective Tax Rate (%)	(22.1)	(22.8)	(25.0)	(25.0)
Net Profit	22.1	21.3	21.1	25.8
Operating Margin (%)	9.1	7.5	10.2	10.5
Pre-tax Margin (%)	9.0	8.9	10.5	11.0
Net-Margin (%)	6.0	5.1	5.2	5.4

1. Investment Highlights/Summary

- Salcon is an engineering specialist offering comprehensive end-to-end services in water and wastewater treatment. Salcon currently owns and operates 7 water concessions and 2 wastewater concessions in China and Malaysia. It also has an effective stake of 36% in Binh An Water Corporation Ltd. which operates under a concession agreement to treat and supply water in Vietnam.
- The Concession segment has been generating steady, recurring profit. We believe its current profit base has yet to reflect the full potential and the design capacity of the Concession segment, as some of its WTPs have yet to commence operations.
- The reduced stake in Salcon Asia will result in earnings dilution in the short term, but the doubling in production capacity will be more than enough to compensate for the earnings dilution.
- The unbilled portion of RM436m will sustain Construction segment profit for the next 1-2 years.
- The stock is currently trading at its NTA of RM0.62/share, which does not reflect the promising long-term prospects of its growing concession-based business in China. Based on our adjusted NTA taking into account the exceptional gain of RM60.1m, its adjusted NTA would increase to RM0.75/share.

2. Company Background/Overview

Salcon is an engineering specialist offering comprehensive end-to-end services in water and wastewater treatment, having successfully completed more than 800 water and wastewater projects both locally and overseas. It currently owns and operates 7 water concessions and 2 wastewater concessions in China and Malaysia. It also has an effective stake of 36% in Binh An Water Corporation Ltd. which is a concession holder to treat and supply water in Vietnam. Its water concessions in China are located mostly in coastal cities, namely Changle County, Nanan City, Haining City, Linyi City, Yizheng in China.

- Key areas of operation

The principal activities of Salcon can be divided into the following categories:

- Concessions;
- Construction; and
- Others

A. Concessions

Salcon is involved in the design, construction, operation and maintenance (O&M) of water treatment plants (WTPs), wastewater treatment plants (WWTPs), sewerage treatment plants (STPs) and raw water transfer projects in Malaysia and China.

- **O&M of water treatment facilities in Negeri Sembilan**
Salcon operates 2 WTPs in Sg Terip and Kuala Jerai with a total capacity of 360 MLD.
- **Concessions in China**
Salcon currently owns and operates 6 water concessions and 2 wastewater concessions in China as listed below:

Concessions in China

Concessions	Ownership	Scope of Works	Production Capacity	Concession Period
Changle New Water Treatment Plant	100%	Full concession for production & supply of water	100 MLD (FY11)	50 years from Jan-04
Changle Sewage Treatment Plant	100%	O&M of sewage treatment plant	40 MLD (FY10)	30 years from Jan-06
Changle Raw Water Transfer Project	100%	New raw water pipelines	100 MLD (FY11)	30 years from Apr-08
Linyi Water Treatment Plant	60%	Full scope - O&M of water supply sources, pipelines, metering & collection	150 MLD (FY10)	30 years from 4Q 06
Haining Water Treatment Plant	60%	Construction of 2 WTPs (each with 150 MLD) in 2 phases	300 MLD (FY10)	30 years from 4Q 06
Nan An Raw Water Supply Project	65%	Raw water pipelines	175 MLD (FY11)	30 years from 2008
Yizheng Water Supply Project	66.7%	Water integration scheme	50 MLD (FY11)	30 years from 1Q 10
Yizheng Sewage Treatment Plant	66.7%	O&M of sewage treatment plant	50 MLD (FY11)	30 years from 1Q 10

- Concession segment as a whole accounted for 22.1% and 67.4% of Group turnover and EBIT in FY10.

B. Construction

Salcon is also in the design and construction of WTP, non-revenue water (NRW) works, wastewater and sewage treatment plants.

As at end-FY10, its current orderbook stood at RM1.3bn, with unbilled portion of RM436m. This translates into a turnover cover of 1.6x based on the turnover of RM271.8m for its construction division for FY10.

Construction Orderbook - Unbilled Portion

Projects	RMm
Labu WTP	62.7
O&M - Sg Terip WTP & Kuala Jelai WTP	36.0
DBKK Sewerage Project	47.8
Kelantan, Seremban & Sandakan NRW	41.4
Pintu Geng WTP	45.7
Medini Iskandar Project	46.5
Sewerage projects	88.7
Others (Balance of works)	14.6
Total (Local)	383.4
Sri Lanka (Kelani, Hambantota, Batticaloa)	27.8
Vietnam (IWS, CP2, DongTam)	25.0
Total (Overseas)	52.8
TOTAL	436.2

C. Others

This smaller division is involved in trading and services of specialised engineering equipment and high precision components. It is complementary to its core water and wastewater divisions.

D. Associated Companies

40%-owned Emas Utilities Corporation Sdn Bhd owns 90% interest in Binh An Water Corporation Ltd. which is a concession holder to treat and supply 100 MLD of potable water to Ho Chi Minh city for 20 years commencing Aug 1999.

- **Revenue Breakdown**

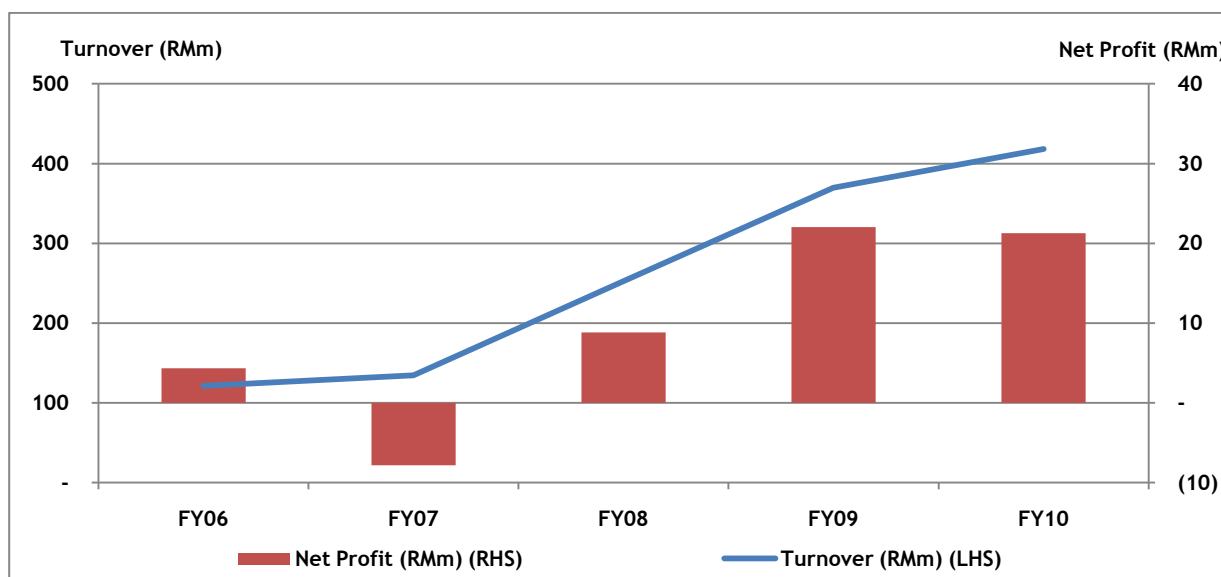
<u>RMm</u>	<u>FY08</u>	<u>FY09</u>	<u>FY10</u>
Construction	164.3	274.1	271.7
Concessions	83.4	88.9	92.5
Others	4.8	6.9	54.0
Group Turnover	252.5	369.9	418.2

- **Profit Breakdown**

<u>RMm</u>	<u>FY08</u>	<u>FY09</u>	<u>FY10</u>
Construction	1.2	10.7	3.6
Concessions	18.8	22.0	21.2
Others	(1.6)	1.0	6.7
Segment Profit	18.3	33.6	31.5
Finance, net	(5.1)	(4.0)	(3.8)
Associate	2.8	3.8	3.6
EI	-	-	5.9
Group PBT	16.0	33.5	37.2

3. **Financial Review**

Historical Turnover and Net Profit Performance



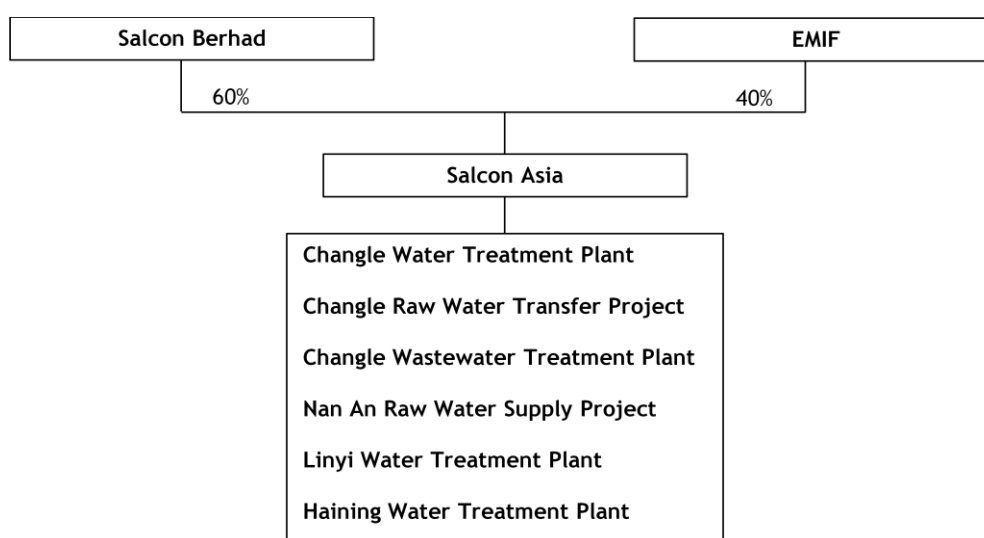
- FY09 net profit chalked up a strong 150.0% increase to RM22.1m due to a strong construction orderbook, higher recognition of construction income and the steadily rising contribution from its China concessions.
- Although turnover continued to rise by 13.1%, its net profit came in marginally lower by 3.6% in FY10. Segment profit from Construction segment dipped to RM3.6m from RM10.7m in FY09. This was mainly attributed to higher construction cost for its Kota Kinabalu sewerage project due to prolonged wet weather condition. However, this was mitigated by one-off higher trading income and a gain of RM5.9m from the disposal of property in FY10.

4. Recent Developments

- **Disposal of 40% stake in Salcon Water (Asia) Limited (Salcon Asia)**
In Nov 2010, under a proposed internal restructuring, Salcon created a 99.99%-owned special purpose vehicle, Salcon Asia to own its existing 6 water concession assets that are currently in operations or under construction in China. 2 more concessions namely Yinzheng water and wastewater concessions, currently managed by Jiangsu Salcon Water & Environmental Development Co Ltd will be injected in 2QFY11.

Consequently, Salcon also announced that it had entered into an agreement with Challenger Emerging Market Infrastructure Fund Pte. Ltd. (EMIF) to sell a 40% stake in Salcon Asia to EMIF for RMB238m (RM112.3m) cash. EMIF is an infrastructure fund established by Mitsui & Co and Challenger Financial Service Group (an ASX-listed investment company) which invests in emerging markets infrastructure sector, specifically in China.

Structure Post-Restructuring and Disposal



The proposed disposal will result in an exceptional gain of RM60.1m. In addition, the net cash proceeds of RM101.1m (net of repayment of borrowings and disposal expenses of RM10m and RM1.2m respectively) will be used for future investment to fund its planned continuing expansion in China. The strategic alliance with EMIF will help to grow Salcon Asia's water assets to a meaningful size for an eventual separate listing over the medium term.

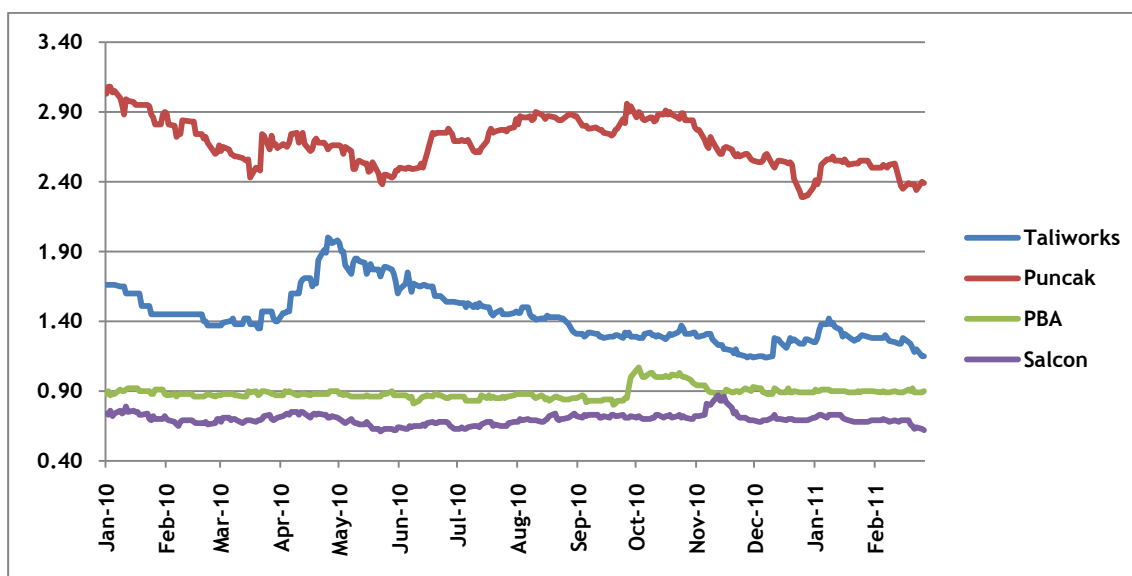
The proposed disposal, which was approved by its shareholders on the EGM on 21 Jan 2011, is expected to be completed in 1QFY11.

- The CEO, Mr. How See Hok announced his resignation on 4 Jan 2011 on his own accord.

5. Competitive Analysis

<u>Comparative Valuation</u>	<u>Taliworks *</u>	<u>Puncak</u>	<u>PBA</u>	<u>Salcon</u>
Share Price (RM) @ 9-Mar-11	1.15	2.34	0.90	0.62
Mkt. Cap (RM mil)	502.0	957.3	296.5	293.6
P/E FY09 (x)	11.2	6.7	20.0	13.1
P/E FY10 (x)	13.4	8.0	11.3	13.8
Latest P/NTA (x)	1.1	0.6	0.5	1.0
Yield (%)	1.0	-	3.4	2.4

Share Price Chart of Taliworks, Puncak, PBA and Salcon



6. Earnings Outlook

- The Concession segment has been generating steady and recurring profit. We believe its current profit base has yet to reflect its full potential and the design capacity of the Concession segment, as some of its WTPs have yet to commence operations.

As shown in table below, the production capacity of its concession in China increased by 29% to 490 MLD as at end-FY10. However, the doubling in capacity of Haining WTP, which was commissioned in 4QFY10, will only impact its P&L in FY11. Furthermore, the additional capacities measuring 475 MLD in total (+97% vs. FY10's 490 MLD) arising from Changle new WTP (100 MLD), Changle Raw Water (100 MLD), Nan An Raw Water (175 MLD) and Yizheng Water Supply (100 MLD) will only come on stream towards the later part of FY11. The full benefits will only be reflected in FY12-FY13.

Production Capacity of China Concessions

Concessions	Production Capacity (MLD) as at end-FY		
	FY09	FY10	FY11
Changle Water Treatment Plant (existing/new)	40	WIP	100
Changle Sewage Treatment Plant	40	40	40
Linyi Water Treatment Plant	150	150	150
Haining Water Treatment Plant	150	300	300
Changle Raw Water Transfer Project	WIP	WIP	100
Nan An Raw Water Supply Project	WIP	WIP	175
Yizheng Water Supply Project	WIP	WIP	50
Yizheng Sewage Treatment Plant	WIP	WIP	50
Total	380	490	965

- Although Salcon has positioned itself to expand its water assets portfolio more aggressively, backed by the additional cash from the disposal, the reduced stake in Salcon Asia will nevertheless result in earnings dilution in the short term. As shown in the table above, the doubling in production capacity will be more than enough to compensate for the earnings dilution.
- Coupled with Salcon's operating track record and history in China, it is also well positioned to secure more concessions in China given its pipeline of projects currently pursued.

- The O&M contract of water treatment facilities in Negeri Sembilan will be expiring in Mar 2012 (Kuala Jerai WTP) and Sep 2012 (Sg Terip WTP). We believe that Salcon, as an existing operator since 2002, and its involvement in a NRW project in Seremban and upgrading works for Sg Terip WTP (from 280 MLD to 325 MLD), commands a higher chance of renewing the O&M contract again.
- For its Construction segment, its current orderbook as at end-FY10 stood at RM1.3bn, with unbilled portion of RM436m. This translates into a turnover cover of 1.6x based on the turnover of RM271.8m for its construction division for FY10. Currently, Salcon is tendering/pre-qualified for more than RM3.0bn new jobs. With historical success rate of 20%, this should translate into RM600m new jobs over the next 2-3 years to replenish its orderbook.

On the local front, Salcon is bidding for the RM1.2bn water treatment plant project under the Langat 2 project with MMC Corp Bhd. Other potential areas include the 10th Malaysian Plan (2011-2015) and NRW project, in which Salcon can leverage on its track record and capability in providing a holistic solution to Sandakan, Seremban and Kelantan.

Overseas, Salcon is also looking for projects in India, Sri Lanka, Cambodia, Vietnam and Indonesia.

7. Key Investment Risks

- The deadlock in the takeover of all water concessionaires in Selangor will continue to dampen market sentiment on water stocks.

8. Balance Sheet

Salcon's balance sheet remains healthy with a net gearing ratio of 0.3x as at end-FY10. Taking into account the exceptional gain of RM60.1m (RM0.13/share), its adjusted NTA would amount to RM0.75/share after the completion of the disposal of 40% stake in Salcon Asia.

<u>Balance Sheet and Other Financial Data (RM mil)</u>	<u>2009</u>	<u>2010</u>	<u>2011F</u>	<u>2012F</u>
Total Assets	744.3	840.0	1,001.2	1,101.0
Fixed Assets	255.6	368.5	382.7	395.6
Current Asset	439.6	422.6	565.8	649.2
LT Assets	49.2	48.9	52.6	56.2
Current Liabilities	295.3	249.9	274.2	341.6
LT Liabilities	69.8	195.9	195.9	195.9
Share Capital	233.9	236.8	236.8	236.8
Shareholders Funds	307.5	309.6	383.7	402.4

9. Valuation and Recommendation

We are maintaining our Buy recommendation on Salcon for the following reasons:

- We believe FY11 profit does not reflect the full potential of its various China concessions. The doubling in production capacity towards the latter part of FY11 will only be reflected in FY12-FY13.
- The stock is currently trading at P/Es of 13.9x and 11.4x for FY11 and FY12. It is also trading at its NTA of RM0.62/share, which does not reflect the promising long-term prospects of its growing concessions in China. In addition, the valuation of Salcon Asia is not reflected in its share price. Taking into account the exceptional gain of RM60.1m, its adjusted NTA would increase to RM0.75/share. We believe the stock should at least trade above its adjusted NTA/share, giving rise to a targeted upside of 21%.

Disclosures/Disclaimer

Investment ratings:

Buy (generally >10% upside over the next 12 months)

Hold (generally negative 10% downside to positive 10% upside over the next 12 months)

Sell (generally >10% downside over the next 12 months)

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