

Recommendation: **BUY**

Stock Code: 8567

Bloomberg: SALC MK

Price: MYR0.63

12-Month Target Price: MYR0.77

Date: May 30, 2008

Board: Main

Sector: Trading/Services

GICS: Utilities/Water Utilities

Market Value - Total: MYR292.3 mln

Summary: Salcon is a water-engineering specialist that designs, constructs and operates water and wastewater treatment systems and plants. Its projects are located in Malaysia, ASEAN and China. It also owns concessions to treat water and wastewater in China and Vietnam.

Analyst: Chok Wai Lee, CFA



Results Review & Earnings Outlook

- Salcon's 1Q08 net profit of MYR1.8 mln (+1035% YoY), was below our expectations, accounting for only 8% of our previous 2008 forecast of MYR22.9 mln.
- The main variance came from lower recognition of construction income from the MYR183 mln Kota Kinabalu Sewage System project due to the rainy season in Sabah. We understand that construction activities have picked up in 2Q08.
- Salcon's water concessions in China improved significantly, contributing pre-tax profit of MYR3.7 mln, well within our expectations. We believe this is mainly due to the contribution from the expanded capacity in the Linyi and Haining water supply concessions.
- Salcon's has reclassified its business into three segments, namely: construction, concessions and others. A comparison is not possible as no historical data was provided.
- We have reduced our net profit forecasts for 2008 and 2009 by 15% and 1% to MYR19.5 mln and MYR25.4 mln, respectively, taking into account the delay in construction projects. Going forward, we believe prospects for Salcon remain bright. Salcon's order book as at end-May 2008 stood at MYR800 mln (unbilled portion MYR650 mln) and it is actively bidding for new projects in the region.

Key Stock Statistics

| FY Dec. | 2007 | 2008E |
|---------------------------------|-------------|-------|
| Reported EPS (sen) | -1.8 | 4.2 |
| PER (x) | NM | 15.0 |
| Dividend/Share (sen) | 0.0 | 0.0 |
| NTA/Share (MYR) | 0.50 | 0.54 |
| Book Value/Share (MYR) | 0.52 | 0.57 |
| No. of Outstanding Shares (mln) | 467.7 | |
| 52-week Share Price Range (MYR) | 0.59 - 1.43 | |
| Major Shareholders: | % | |
| Naga Muhibbah Sdn. Bhd. | 15.7 | |
| EPF Board | 3.6 | |

*Stock deemed Shariah compliant by the Securities Commission.

Recommendation & Investment Risks

- We maintain our Buy recommendation on Salcon with a lower 12-month target price of MYR0.77 (from MYR0.85) following our earnings revisions.
- We continue to value Salcon based on a sum-of-parts method that is derived from discounted cash flow estimates of Salcon's concessions in China and Vietnam, and order book-related activities.
- Salcon has ambitious plans to raise its water and wastewater treatment concessions in China to 1,000 mln litres/day (mld) from the current 400 mld through a combination of organic expansion and new concessions.
- We believe the group is poised for a strong turnaround going forward and the investments in China are beginning to take off and contribute meaningfully to its bottom line. Share price catalysts could also include, in our view, positive news flow on potential concessions and construction related contracts in Malaysia and overseas.
- Risks to our recommendation and target price include slower-than-expected replenishment of its order book and commencement of new construction projects, higher-than-expected costs, collection issues and regulatory issues for the China concessions that could lead to lower water tariffs. With the recent political changes domestically, water projects in the country may also be much slower in taking off.

Per Share Data

| FY Dec. | 2005 | 2006 | 2007 | 2008E |
|-------------------------|-------|------|------|-------|
| Book Value (MYR) | 0.51 | 0.53 | 0.52 | 0.57 |
| Cash Flow (sen) | -5.0 | 4.8 | -0.4 | 5.5 |
| Reported Earnings (sen) | -14.2 | 2.0 | -1.8 | 4.2 |
| Dividend (sen) | 0.0 | 0.0 | 0.0 | 0.0 |
| Payout Ratio (%) | 0.0 | 0.0 | 0.0 | 0.0 |
| PER (x) | NM | 30.6 | NM | 15.0 |
| P/Cash Flow (x) | NM | 13.1 | NM | 11.3 |
| P/Book Value (x) | 1.2 | 1.2 | 1.2 | 1.1 |
| Dividend Yield (%) | 0.0 | 0.0 | 0.0 | 0.0 |
| ROE (%) | -12.5 | 3.9 | -4.5 | 8.4 |
| Net Gearing (%) | 28.6 | 74.6 | 12.6 | 0.0 |

FY04: July YE, FY05: 17 months to Dec. 2005

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Quarterly Performance

| FY Dec. / MYR mln | 1Q08 | 1Q07 | % Change |
|---------------------------------|------|------|----------|
| Reported Revenue | 45.3 | 27.4 | 65.1 |
| Reported Operating Profit | 3.2 | 0.9 | >100 |
| Depreciation & Amortization | NA | NA | NA |
| Net Interest Income / (Expense) | -1.1 | -1.2 | -3.3 |
| Reported Pre-tax Profit | 2.8 | 0.8 | >100 |
| Reported Net Profit | 1.8 | 0.2 | >100 |
| Reported Operating Margin (%) | 7.2 | 3.3 | - |
| Reported Pre-tax Margin (%) | 6.2 | 2.8 | - |
| Reported Net Margin (%) | 4.0 | 0.6 | - |

Source: Company data

Profit & Loss

| FY Dec. / MYR mln | 2006 | 2007 | 2008E | 2009E |
|---------------------------------|-------|-------|-------|-------|
| Reported Revenue | 121.3 | 134.6 | 250.8 | 338.2 |
| Reported Operating Profit | -1.6 | -6.9 | 32.0 | 39.7 |
| Depreciation & Amortization | -5.8 | -6.0 | -6.3 | -6.6 |
| Net Interest Income / (Expense) | -4.2 | -3.1 | -3.4 | -3.8 |
| Reported Pre-tax Profit | 0.5 | -4.8 | 33.8 | 41.1 |
| Effective Tax Rate (%) | NM | NM | 26.0 | 25.0 |
| Reported Net Profit | 4.3 | -7.5 | 19.5 | 25.4 |
| Reported Operating Margin (%) | -1.3 | -5.1 | 12.8 | 11.7 |
| Reported Pre-tax Margin (%) | 0.5 | -3.6 | 13.5 | 12.2 |
| Reported Net Margin (%) | 3.6 | -5.6 | 7.8 | 7.5 |

Source: Company data, S&P Equity Research

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Glossary

Strong Buy: Total return is expected to outperform the total return of the KLCI or KL Emas Index respectively, by a wide margin over the coming 12 months, with shares rising in price on an absolute basis.

Buy: Total return is expected to outperform the total return of the KLCI or KL Emas Index respectively, over the coming 12 months, with shares rising in price on an absolute basis.

Hold: Total return is expected to closely approximate the total return of the KLCI or KL Emas Index respectively, over the coming 12 months with shares generally rising in price on an absolute basis.

Sell: Total return is expected to underperform the total return of the KLCI or KL Emas Index respectively, over the coming 12 months and share price is not anticipated to show a gain.

Strong Sell: Total return is expected to underperform the total return of the KLCI or KL Emas Index respectively, over the coming 12 months by a wide margin, with shares falling in price on an absolute basis.

S&P 12 Month Target Price – The S&P equity analyst's projection of the market price a given security will command 12 months hence, based on a combination of intrinsic, relative, and private market valuation metrics.

Shariah-compliant stock - As defined by the Shariah Advisory Council of Malaysia's Securities Commission

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For residents of Malaysia. All queries in relation to this report should be referred to Alexander Chia, Desmond Ch'ng or Ching Wah Tam.

Recommendation and Target Price History

| Date | Recommendation | Target Price |
|-----------|----------------|--------------|
| New | Buy | 0.77 |
| 22-Apr-08 | Buy | 0.85 |
| 6-Sep-07 | Hold | 1.17 |
| 26-Jun-07 | Buy | 0.99 |
| 4-Dec-06 | Hold | 1.08 |
| 30-Aug-06 | Hold | 0.44 |
| 24-May-06 | Strong Buy | 0.47 |
| 30-Mar-06 | Buy | 0.50 |

