

Recommendation: **BUY**

Stock Code: 8567

Bloomberg: SALC MK

Price: MYR0.72

12-Month Target Price: MYR0.85

Date: April 22, 2008

Board: Main

Sector: Trading/Services

GICS: Utilities/Water Utilities

Market Value - Total: MYR336.8 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



Highlights

- Salcon reported a net loss of MYR7.5 mln in 2007. The disappointing results were mainly due to a one-off loss (about MYR7 mln) from the disposal of an associate as well as bad debts written off and impairment in investments amounting to MYR2 mln.
- In the absence of the non-recurring items in 2007, we expect Salcon's earnings to rebound significantly in 2008 to MYR22.9 mln. The strong growth is mainly due to recognition of contribution from the newly secured MYR183 mln sewage contract in Kota Kinabalu, Sabah. In addition, we also expect a jump in contribution from its China water concessions, as 2008 should see the first full-year contribution from the expanded capacity in the Linyi and Haining water supply concessions.
- We expect earnings to grow by 12.2% YoY to MYR25.7 mln in 2009, driven by increased contribution from its China activities.

Investment Risks

- 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.

Recommendation

- We resume coverage on Salcon with a Buy recommendation and a 12-month target price of MYR0.85. 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.
- We continue to value Salcon based on a sum-of-parts method that is derived from discounted cash flow estimate 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.
- Over the longer term, its China concessions could benefit from rising water tariffs as the Chinese government grapples with potentially crippling clean water shortages. Share price catalysts could also include, in our view, positive news flow on potential concessions and construction related contracts in Malaysia and overseas.
- From Salcon's website and 2006 annual report, we note that there was no mention of any corporate social responsibility (CSR) activities that may have been undertaken by the group.

Key Stock Statistics

FY Dec.	2007	2008E
Reported EPS (sen)	-1.8	4.9
PER (x)	NM	14.7
Dividend/Share (sen)	0.0	0.0
NTA/Share (MYR)	0.50	0.55
Book Value/Share (MYR)	0.52	0.58
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.

Per Share Data

FY Dec.	2005	2006	2007	2008E
Book Value (MYR)	0.51	0.53	0.52	0.58
Cash Flow (sen)	-5.0	4.8	-0.4	6.2
Reported Earnings (sen)	-14.2	2.0	-1.8	4.9
Dividend (sen)	0.0	0.0	0.0	0.0
Payout Ratio (%)	0.0	0.0	0.0	0.0
PER (x)	NM	35.3	NM	14.7
P/Cash Flow (x)	NM	15.1	NM	11.5
P/Book Value (x)	1.4	1.4	1.4	1.2
Dividend Yield (%)	0.0	0.0	0.0	0.0
ROE (%)	-12.5	3.9	-4.5	9.8
Net Gearing (%)	28.6	74.6	12.6	38.9

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

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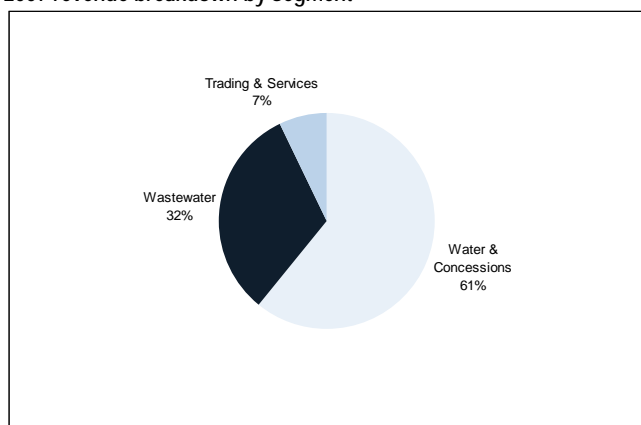
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Business

Salcon is an investment holding company, which through its subsidiaries, designs, builds, operates, and maintains municipal potable water, sewerage, and industrial wastewater facilities. It also provides mechanical and electrical engineering services for general industries. The Group's operations are spread across Malaysia, Vietnam, Thailand, Sri Lanka and China.

Salcon was incorporated on Sep. 22, 2002, and was listed on the Main Board of Bursa Malaysia in September 2003 in a reverse takeover of the listing status of Seng Hup Corporation Berhad.

Salcon divides its activities into three main segments: (1) Water and Concessions; (2) Wastewater; and (3) Trading and Services. Water and Concessions includes projects that involve the design and construction of water treatment plants as well as concessions in China. Similarly, the Wastewater segment refers to projects involving the design and construction of wastewater and sewerage treatment plants. Trading and Services consists of the distribution of related equipment and other engineering services. Besides the China water concessions, Salcon owns a 36% stake in a Vietnamese water treatment concession.

2007 revenue breakdown by segment

Source: Company data

Water & Concessions

Salcon bids for design, engineering and construction contracts in ASEAN with Malaysia currently being the largest market, although a prolonged delay in fresh spending in the country and success in overseas bids may change the geographical makeup. Salcon's current order book totals MYR929 mln, of which around MYR678 mln is unbilled.

Given the deferment of planned spending for water treatment facilities in Malaysia, Salcon has switched its focus to the operation & maintenance (O&M) of facilities and to undertaking efforts to tackle the Non-Revenue Water (NRW) issues in Malaysia. NRW denotes water that is distributed to the end-user but for which revenue is not collected either through inefficient billing and collection systems or through water leaks such that not all output reaches the customer. One benefit of the move into more O&M activities is that 19% of its order book now consists of long-term recurring contracts.

Salcon also undertakes the O&M of the Sungai Terip, Jelai, and Kepis water treatment plants. Its NRW activities focus on managing water pressure, controlling leakage, repairing facilities and infrastructure and

managing pipe materials. It is currently undertaking NRW projects in Sabah and Negeri Sembilan and bidding for more such projects to shore up its order book. We understand that Salcon has tendered for approximately MYR700 mln worth of new jobs locally.

Due to the recent political changes, the deferment of planned spending for the water sector in Malaysia is expected to continue in the near term, in our opinion. However, we are not overly concerned about this issue as Salcon is actively bidding for new projects abroad. Outside of Malaysia, Salcon is eyeing engineering and construction contracts in India, Sri Lanka, Indonesia and Vietnam, particularly those funded by multilateral organizations. To date, the group has outstanding bids for overseas new projects of around MYR1.1 bln.

Besides, the group's water concessions are an increasingly important part of earnings and we believe they will be the main earnings driver in the future. Salcon owns five water treatment and distribution concessions in China, which were acquired either through a Build-Operate-Transfer (BOT) or Transfer-Operate-Transfer (TOT) arrangement with the municipal governments. The group also sees significant contribution through its Vietnamese associate company that treats and supplies potable water to Ho Chin Minh City (Binh An water supply).

Salcon's water concessions

Concession name	Duration	% owned	Capacity (mld)
Changle water supply, China	50 years	100%	40.0
Changle wastewater, China	50 years	100%	40.0
Chengong water supply, China	30 years	60%	20.0
Linyi water supply, China	30 years	60%	150.0
Haining water supply, China	30 years	60%	150.0
Binh An water supply, Vietnam	20 years	36%	100.0

Source: Company data

Salcon's total capacity for its water and wastewater concessions in China is around 400 mld. It is still looking to raise its capacity in China and management's target is a total of 1,000 mld capacity by end-2011. The tariff rates for its Changle wastewater and Haining water supply concessions are reviewed annually and are benchmarked against the escalation of operating costs. For the remaining concessions, Salcon can apply for tariffs adjustment with the local pricing bureau if the current tariffs are insufficient to compensate for operating costs. Recently, Salcon managed to apply for a tariff adjustment for its Linyi Water concession in January 2008.

Since early 2008, Salcon has announced four new overseas projects:

(1) Joint venture with Nan An municipal government, China to participate in the construction and O&M of a 48km raw water pipeline to supply raw water to the Nan An Coastal 3-towns for a concession period of 30 years. The project will be implemented in two phases, that is 170 mld in Phase I and 175 mld in Phase II, bringing a total of 345 mld of raw water to the Coastal 3-towns. The investment cost of the project is estimated at approximately MYR172 mln and the commercial run is expected to start in 2009. Salcon will hold a 65% stake in the project.

- (2) Joint venture with Per Aarsleff A/S, Denmark to design and construct Kelani Right Bank water treatment plant (40 million gallons per day) in Sri Lanka. Salcon's portion of work corresponds to 40% of the total contract value, i.e. approximately MYR88.4 mln. This is Salcon's third water treatment project in Sri Lanka.
- (3) Construction of a new 100 mld water treatment plant in Changle, China. This is an expansion of the treatment capacity under the existing concession. The cost for the new plant is estimated at approximately MYR45.5 mln.
- (4) Design, construction, O&M of a pumping station at Gaoya Reservoir and new raw water pipelines from the reservoir to the raw water pipelines in Changle, China. The total length of the new raw water pipelines is 38km. The investment is estimated at approximately MYR49.6 mln and the concession period is 30 years from the commercial operation.

We remain positive on these new contracts, which would help Salcon in replenishing its order book and grow its concessions in China. Based on its proven track record, we are confident that Salcon will be able to secure more overseas contracts to mitigate the impact of a slowing domestic construction order book.

Wastewater

Salcon undertakes activities related to wastewater treatment mainly through 60%-owned subsidiary Envitech. The group has completed more than 300 projects in Malaysia and is involved in the design, construction, upgrade, refurbishment and O&M of sewage and wastewater treatment facilities, as well as the manufacture of related equipment. In 2007, Salcon secured a MYR183 mln sewage contract in Kota Kinabalu, Sabah. The scope of works include new sewage works in Inanam and Penampang catchment areas as well as refurbishment works for pumping stations in Kota Kinabalu city centre.

Trading & Services

Salcon markets and distributes a range of products used for specialized engineering purposes and precision components used in various industries. Services provided include the repair and modification of pumps, valves and turbines and general fabrication works. We do not expect significant contributions from this division going forward given its small base.

Salcon announced in June 2007 that it had entered into a conditional share sale agreement with Maika Holdings Berhad (Maika) to acquire 74% of the issued and paid-up share capital of Oriental Capital Assurance Berhad (OAC) from Maika for a total cash consideration of MYR130 mln. OAC is engaged principally in the underwriting of all classes of general insurance. However, we understand that Salcon has requested for an extension of time to complete the proposed acquisition (which expired Feb. 22, 2008) as Salcon is still waiting for Maika to settle a court injunction by some minority shareholders who object to the sale of OAC. We understand that Salcon may not proceed with the deal if it drags on too long and will instead focus on its water and wastewater business.

To recap, the main rationale for entering into the insurance business is to derive more long-term and stable recurring income, thus reducing reliance on the cyclical construction industry. Salcon is not new to the insurance industry, as its Vice Chairman, Dato' Seri Goh Eng Toon and its advisor, Dato' Tee Tiam Lee, are former chairman of Aviva Insurance Berhad and co-founding member of Kurnia Insurance (KUAB MK, MYR2.35, Not Ranked), respectively. We have not factored in any earnings contribution from OAC into our model, pending for further announcement.

Earnings Outlook

Salcon reported a net loss of MYR7.5 mln in 2007. The disappointing results were mainly due to a one-off loss (about MYR7 mln) from the disposal of an associate, as well as bad debts written off and impairment in investments of MYR2 mln. The disposal was part of the management's effort to divest non-core businesses and focus on the water and wastewater businesses.

In the absence of the non-recurring items in 2007, we expect Salcon's earnings to rebound significantly in 2008 to MYR22.9 mln. The strong growth is mainly due to recognition of contribution from the newly secured MYR183 mln sewage contract in Kota Kinabalu, Sabah, which commenced end-2007. In addition, we also expect a jump in contribution from its China water concessions, as 2008 should see the first full-year contribution from the expanded capacity in the Linyi and Haining water supply concessions. Associate income from Binh An is forecast to remain stable at around of MYR5.2 mln.

We expect earnings to grow by 12.2% YoY to MYR25.7 mln in 2009, driven by stable contribution from its China activities. We have also factored in higher recognition of water and wastewater treatment contracts of MYR242 mln. In our view, prospects for Salcon remain bright, as Salcon has proven its ability to win new mandates and grow its order book.

Valuation

Our target price of MYR0.85 for Salcon is 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.

We believe Salcon 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. Salcon's present 2008 PER valuation of 14.7x is comparable to that of its peers (average 14.5x), but at the low end of its historical trading range.

We think the risks of a slowing domestic construction order book are largely priced in, given the sharp fall in its share price (-40% YTD). Going forward, Salcon targets to increase its revenue contribution from China concessions to 40%-50% over the next three years, from 27% presently. In our view, this would reduce Salcon's dependence on earnings from construction projects. The stock should receive a boost when it secures new projects that we have yet to reflect in our forecasts.

Profit & Loss

FY Dec. / MYR mln	2006	2007	2008E	2009E
Reported Revenue	121.3	134.6	289.2	345.0
Reported Operating Profit	-1.6	-6.9	37.8	45.1
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	39.6	46.5
Effective Tax Rate (%)	NM	NM	26.0	25.0
Reported Net Profit	4.3	-7.5	22.9	25.7
Reported Operating Margin (%)	-1.3	-5.1	13.1	13.1
Reported Pre-tax Margin (%)	0.5	-3.6	13.7	13.5
Reported Net Margin (%)	3.6	-5.6	7.9	7.4

Source: Company data, S&P Equity Research

Standard & Poor's Equity Research Services

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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	0.85
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

