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China

Miscellaneous

Reuters 0855.HK
Bloomberg 855 HK

Priced on 7 June 2007

HS CEI @ 10,956.7

12M hi/lo HK\$5.18/1.48

12M price target HK\$6.06

±% potential +33%

Target set on 8 Jun 07

Shares in issue 1,203.9m

Free float (est.) 56.9%

Market cap US\$693m

3M average daily volume

HK\$35.2m (US\$4.5m)

Major shareholders

Duan Chuan Liang 12.1%
L-R Global Partners, L.P. 9.2%

Stock performance (%)

	1M	3M	12M
Absolute	(9.0)	49.2	145.9
Relative	(12.8)	20.9	49.1
Abs (US\$)	(8.9)	49.2	144.3



Source: Bloomberg

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Capturing future growth

CWA has a proven ability to secure new projects and boosted its capacity by 4.4 times in just the past couple of months. We believe deal flows will remain strong through to FY09 and based on our conservative assumptions of one additional project in FY09, have revised up our target price to HK\$6.06, implying 24x CY08 PE or 19x CY09 PE. BUY.

Adding minimum capacity for FY09 to reflect valuation upside

Our meeting with management confirmed our view that future deal flows are likely to continue aggressively. The group's target of reaching 10m tons capacity by 2011 now appears more realistic with the addition of 2.1m tons capacity in the past 4 months (4.4 x the capacity at the start of the year) with the Foundation Water deal already contributing an additional 1m tons capacity. We are, however, taking a more conservative view and assuming an additional project with 500k tons capacity in FY09. If the capacity addition is as strong as management expect, our scenario analysis suggests fair value for the stock at over HK\$10/share.

Recent hydropower deal – Limited growth

Despite an apparent lack of synergy for hydropower to fit into the supply chain, the valuation for the deal only accounts for 4% of the estimated group NAV. CWA injected Rmb228m for a 45% stake in the Jianghe Long Chuan Electricity Dev. which has hydropower assets with attributable installed capacity of 123MW. The acquisition price was not particularly attractive at an EV of US\$1.76m/MW despite an above average despatch ratio of 51%. We are negative on the hydropower business since its growth is likely to be dampened by the worsening drought in China.

Full year FY07 results out end of next month

We are expecting first full year profit to come in at HK\$47m when the company announces results at the end of next month. With the group's trading securities investment in Qianjiang Water (600283 CH), whose share price rallied 93% from CWA's purchase price of RMB4.56/share, we expect an unrealised gain of HK\$120m, or 1.45x our FY07 core earnings forecast.

Upgrade to HK\$6.06/share

We are upgrading our target price by 19% to HK\$6.06/share based on our sum of parts valuation, after incorporating projects that lifted FY08CL and FY09CL by 12% and 18%, respectively. The stock is trading at 20.4x CY08 PE versus an average 21.4x for H-share pure play peers. Given its high CY07-10CL EPS Cagr of 49%, the stock deserves a premium. BUY.

Financials

Year to 31 Mar	06A	07CL	08CL	09CL	10CL
Revenue (HK\$m)	52.90	217.41	1,013.78	1,709.63	2,286.14
Net profit (HK\$m)	(38.59)	46.25	169.08	302.31	380.86
NP forecast change (%)			11.8	18.0	25.2
EPS (HK¢)	(8.0)	4.1	13.8	24.9	31.4
CL/consensus(2)(EPS%)	-	82	96	119	-
EPS (% YoY)	(17.9)	(151.6)	234.2	80.8	25.9
PEX (@HK\$4.55)	(57.0)	110.4	33.0	18.3	14.5
Dividend yield (%)	-	-	-	-	-
FCF yield (%)	(6.6)	0.1	3.0	4.1	5.0
ROAE (%)	(27.10)	8.00	17.00	24.60	24.30
Net cash (HK\$m)	235	443	0	1,036	1,663

Source: CLSA Asia-Pacific Markets

A fair value of HK\$8.78/share will only reflect a daily capacity of 6.15mtons – 39% below CWA's target of 10m tons

We are assuming a dummy project to have an average capacity of 500,000 tons

Other than the announced projects, we currently have in our model 4 remaining MOUs expected to be delivered in 1HFY08 and 1 newly assumed project for delivery in FY09. We believe that the 500,000 tons capacity is a minimum capacity addition for the group in FY09 given that management sets FY08-09 as the highest growth period and expects its capacity to reach 10m tons by 2011. Having acquired projects with a combined capacity of 2.1m tons in the past few months, if the group keeps this pace of acquisition by adding over 2m tons in FY09 its value could go beyond the blue sky valuation of HK\$8.78/share. However, we are only assuming one project in FY09, as we are cautious on the sustainability of the pace of deal flows and the ability of the group in delivering earnings after such strong project deliveries.

Figure 1

Further upside

	No. of projects in FY09	Total daily capacity (m tons)	Estimated value (HK\$/share)
Base Case	1	4.15	6.06
Scenario 1	2	4.65	6.74
Scenario 2	3	5.15	7.42
Scenario 3	4	5.65	8.10
Blue-sky	5	6.15	8.78

Source: CLSA Asia-Pacific Markets

Figure 2

Assumptions for the dummy project

Weighted average daily capacity per new project ('000 tons)	500
% debt/(debt+equity)	30%
% ownership	51%
EV/ton (RMB)	756
Weighted average leakage	18%
Weighted average utilisation rate	60%
Weighted average residential tariff (RMB/ton)	1.62
Weighted average industrial tariff (RMB/ton)	1.91
Weighted average % industrial to total volume	44%

Source: CLSA Asia-Pacific Markets

Figure 3

Group Valuation Summary

	HK\$000	HK\$/share	% of group NAV	Comments
Water-related business	6,885,847	5.85	96%	DCF, 10.6% WACC
Seabuckthorn business - 50% of Consec Seabuckthorn Co. Ltd.	253,212	0.22	4%	7.4x FY08 PE
Hydropower - 45% of Jianghe Long Chuan Electricity Dev. Co. Ltd.	285,148	0.24	4%	DCF, 8.8% WACC, EV/EBITDA of US\$2m/MW
GAV	7,424,208	6.30	104%	
Net cash (net debt)	- 282,648	(0.24)	-4%	
NAV	7,141,559	6.06	100%	
NAV (HK\$/share)	6.06			
Current share price (HK\$/share)	4.55			
Upside	33%			

Source: CLSA Asia-Pacific Markets

The group has announced projects with a combined daily capacity of 2.12m tons, boosting the group capacity from 0.616m tons to 2.73m tons.

From our model which has always factored in the 4 remaining MOUs in FY08, an expected FY08 capacity of 3.65m ton would already foregone the management's target

Figure 4

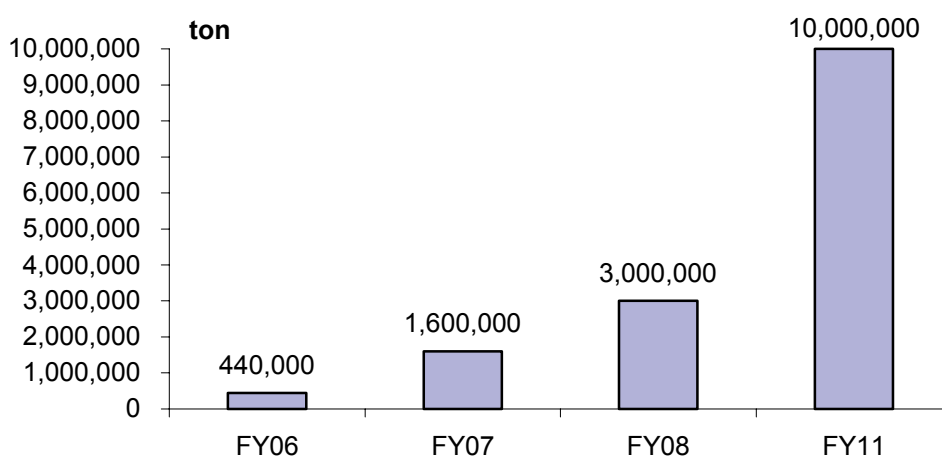
Project delivered so far in 2007 - Boosted capacity by 4.4x in just a few months.

Province	City	Acquisition Date	Capacity ('000 tons/day)
Guangdong	Xinhui	Feb-07	300
Hubei	Jingzhou	Feb-07	715
Jiangxi	Gaoan	Apr-07	45
Foundation Water			
Guangxi	Wuzhou	Apr-07	355
Hainan	Xingshui	Apr-07	100
Jiangshu	Wujin	Apr-07	600
Total Capacity additions ('000 tons/day)			2,115

Source: CLSA Asia-Pacific Markets, CWA

Figure 5

Management has reiterated its capacity targets



Source: CWA

Recommendation history - China Water Affairs Group 855 HK

Date	Rec level	Closing price	Target
08 June 2007	BUY	4.55	6.06
30 April 2007	BUY	4.40	5.09
12 February 2007	BUY	3.55	4.30
23 January 2007	BUY	2.71	3.62
16 April 2006	N-R	1.69	

Source: CLSA Asia-Pacific Markets

Key to CLSA investment rankings: BUY = Expected to outperform the local market by >10%; O-PF = Expected to outperform the local market by 0-10%; U-PF = Expected to underperform the local market by 0-10%; SELL = Expected to underperform the local market by >10%. Performance is defined as 12-month total return (including dividends).

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