1 April, 2019

Hebei Construction (1727 HK): Proxy to the multi trillion construction project

Hebei Construction	
Stock code	1727
# of domestic shares (million)	1300.0
# of H shares (million)	461.4
# of shares issued (million)	1761.4
Price (March 28th 2019) (HK$)	7.1
H-share Mkt cap (HK$ million)	3275.8
12-months target price (HK$)	10.2
Recommendation	Buy

Sources: Hebei Construction, HKEx

Shareholding structure

	# of shares held (million)	% of shareholding
H-shares		
HWABAO TRUST CO., LTD	79.3	4.5
Juli Group	68.1	3.9
KING PAK FU	36.6	2.1
Domestic shares		
Qianbao Investment	1,300.0	73.8

Sources: Hebei Construction, HKEx

Investment theme

Positive earnings outlook. Hebei Construction's net income CAGR in FY18A and FY21F is projected to be 12.7% on modeled revenue CAGR of 9.4% and GPM assumption of 4.6%. Growth in revenue in FY18F-FY21F is expected to be driven by the increase in new contracts and ongoing contracts backlogs for projects concerning the development of Xiongan New Area, urbanization of Baoding and ongoing development in BTH Region; and expanding market share in BTH Region.

A "Buy" call. Our target price of HK$10.2 per H-share equivalents to FY19F PE/G of 0.8x, which is justified by its geographical competitive advantages in Baoding, strong financial position with CNY3.0b net cash on its balance sheet as of the end of December 2019, highest projected ROE of 26.4% among its peers and projected FY19F dividend yield of 6.4%. With potential upside of 43.6%, we initiate coverage on the group with Buy rating.

Geographic competitive edges. Ongoing synergic development in BTH Region, urbanization in Baoding and the multitrillion Xiongan New Area development projects are expected to boost the output value CAGR of construction industry in BTH region to 9.0% in FY18F and FY21F. In particular, fixed-assets investment for the establishment of Xiongan New Area is estimated to exceed CNY400b between 2017 and 2021. As a leading non-state-owned contractor with headquarter in Baoding where Xiongan New Area is located, Hebei Construction is expected to reap a big chunk from regional construction boom.

Lower VAT and SSF contribution. Premier Li Keqiang addressed in his annual government work report that VAT for construction enterprises would be reduced from 10.0% to 9.0%, following the 1.0% VAT reduction in May 2018. Proportion of social security funds contribution by employers would be lower to 16.0% too. Those measures would boost up contractors' revenue and profit.

Chinese contractors are about to be rerated. With dim outlook of international trade on evolving Sino-US trade disputes and obscure global economy outlook; and lackluster domestic consumption growth outlook, infrastructure/construction sector remains as one of the few sectors with growth momentum in China. Contractors' revenues outlooks are positive upon expected 5.9% and 6.1% growth in national construction spending, respectively, for 2019 and 2020, and 2.0 ppts reduction in VAT. "One Belt, One Road" initiatives conducted by the PRC government would introduce opportunities abroad to domestic contractors. Proportion of social security fund contribution for contractors lower to 16.0% would reduce contractor's staff costs hence enhance their profitability. Notwithstanding with the potential upsides, HK-listed China based contractors are somewhat undervalued. As one of few sectors with high earning visibility, the construction sector as a whole is justified for rerating in our view.

Hebei Construction. Established in 1997 with headquartered in Baoding, Hebei Construction is a leading non-state owned construction contractor in BTH region. The group was listed on HKEx by offering 433.3m H-shares at HK$4.46 each in December 2017. In January 2018, the group issued and allotted about 28.0m H-shares at HK$4.46 each.

Key financial data

	FY16A	FY17A	FY18A	FY19F	FY20F	FY21F	FY22F
Revenue (CNY million)	38,609.4	41,177.3	46,649.2	51,823.9	60,303.5	61,066.3	66,120.2
Gross profit (CNY million)	1,882.8	2,231.0	2,566.9	2,419.1	2,822.4	2,857.0	3,095.2
Pre-tax profit (CNY million)	1,308.0	1,564.9	1,606.7	2,092.4	2,453.3	2,329.5	2,541.0
NP to shareholder (CNY million)	768.2	1,052.2	1,173.4	1,509.2	1,769.5	1,680.2	1,832.8
Dividend (CNY million)	14.9	1,531.4	528.4	679.1	796.3	756.1	824.8
Equity (CNY million)	2,834.2	3,902.7	5,177.8	5,717.1	6,457.7	7,149.2	7,924.6
Fully diluted EPS (CNY)	0.4361	0.5974	0.6662	0.8568	1.0046	0.9539	1.0405
Fully diluted BPS (CNY)	1.6091	2.2157	2.9396	3.2458	3.6663	4.0589	4.4991
Fully diluted DPS (CNY)	0.0084	0.8694	0.3000	0.3856	0.4521	0.4293	0.4682

Financial ratios

	FY16A	FY17A	FY18A	FY19F	FY20F	FY21F	FY22F
Gross margin (%)	4.9	5.4	5.5	4.7	4.7	4.7	4.7
Pretax margin from continuing operations	3.4	3.8	3.4	4.0	4.1	3.8	3.8
Net margin (%)	2.0	2.6	2.5	2.9	2.9	2.8	2.8
ROE (%)	27.1	27.0	22.7	26.4	27.4	23.5	23.1
Payout (%)	-	-	45.0	45.0	45.0	45.0	45.0
PE	13.9	10.2	9.1	7.1	6.0	6.4	5.8
Dividend yield (%)	-	-	4.9	6.4	7.4	7.1	7.7

Financial analysis

Revenue growth prospect. Revenue generated from Hebei Construction's building construction contracting business and infrastructure construction contracting business accounted for respective 67.0% and 24.2% of total revenue generated from construction contracting business for FY18A. As the group took on more residential construction projects adjacent to Xiong' an New Area and industrial construction projects outsides BTH region such as in Yangtze River Delta, its revenue generated from building construction contracting business increased by 16.8% YoY for FY18A. Meanwhile, thanks to the CNY572.0m increase in revenue from municipal infrastructure construction projects and CNY679.0m increase in revenue from transportation infrastructures constructions projects, the group generated 13.2% more revenue from its infrastructure construction contracting business than last year. Bolstered by the growth in revenue of the two businesses, Hebei Construction's revenue from construction contracting business increased by 14.0% YoY to CNY44.3b for FY18A, accounting for 94.9% of its total revenue.

Orders on hand increased. Value of the group's new contract acquired in FY18A increased by 10.5% YoY to CNY67.7b, while value of its ongoing contract backlog increased by 21.2% YoY to about CNY81.6b. 64.0% and 25.4%, respectively, of the value of new contract acquired in FY18A were contracts for building construction and infrastructure construction. Meanwhile value of ongoing contract backlog for building construction and infrastructure represented about 70.0% and 21.1%, respectively of its ongoing contract backlog value. In our view, growth momentum in the group's contracts acquired would be strong in forthcoming years upon the increase in number of projects concerning the development of Xiongan New Area, urbanization of Baoding and the ongoing development in BTH Region. Given the value of the group's contracts in hand and backlog, its three-year revenue CAGR in FY18A and FY21F is modeled to be 9.4%, outpacing the three-year output value CAGR of BTH region construction industry at 9.0% projected by Frost & Sullivan, given its low base for comparison, competitive edges among its peers in winning regional projects as well as expanding market share in BTH Region.

GPM and net income outlook. The 0.5ppts expansion in the group's blend GPM of 4.6% for FY18A was attributable to 0.3ppts and 2.2 ppts enhancement, respectively, in GPM of its building construction contracting business (3.9%) and infrastructure construction contracting business (6.9%), thanks to better cost containment and efficiency. We modeled GPM at 4.6% throughout FY19F-21F earnings projection, in line with GPM for FY18A. Mainly due to the 14.0% growth in its construction contracting revenue and 0.5 ppts expansion in blend GPM, the group's net profit for shareholders increased by 5.7% YoY to CNY1,112.5m. Based upon our revenue growth and GPM assumption throughout FY19F and FY21F, we project the group's net earnings to increase at three-year CAGR of 12.7% in FY18A-FY21F, albeit we yet to factor in potentials revenue and profit upsides introduced by 2.0 ppts VAT reduction and lower social security fund contribution to 16.0%.

Table 5: Peer valuation

Code	Company	Mkt Cap (HK$ m)	Curr. P/E (X)	1-yr forward P/E	Curr. ROE	1-yr forward ROE	Curr. PEG	1-yr forward PEG
3311.HK	China State Construction	37,262.8	6.3	5.3	14.1	14.9	0.3	0.3
2009 HK	BBMG CORP-H	48,069.0	6.0	5.8	7.6	8.2	0.3	0.3
1618 HK	Metallurgical	77,364.2	6.6	5.4	8.3	8.7	0.4	0.3
1800 HK	China Comm. Cons.	203,192.1	5.4	5.0	11.0	10.6	0.8	0.8
1186 HK	China Rail Con.	171,154.7	6.5	5.8	11.9	12.3	0.5	0.4
390 HK	China Rail Group	184,984.0	7.7	6.9	11.6	11.7	0.5	0.5

Sources: Bloomberg, Great Roc Capital Securities

Valuation. At projected three-year earnings CAGR of 12.7% and H-share price at HK$7.10, the group trades at FY19F and FY20F PEG of 0.56x and 0.48x, respectively. Our target price of HK$10.2 is equivalent to FY19F PEG of 0.8x, representing 33.3% premium on the peer group's weighted average FY19F PEG of 0.6x. The target valuation is justified by the group's geographical competitive advantages in Baoding, strong financial position with CNY3.0b net cash on its balance sheet as of the end of December 2019, highest projected ROE of 26.4% among its peers and projected FY19F dividend yield of 6.4%. With potential upside of 43.6%, we initiate coverage on the group with Buy rating.

Chinese construction contractors would be rerated. Listed contractors' revenues outlooks are positive upon expected 5.9% and 6.1% growth in national construction spending for 2019 and 2020, and 2.0 ppts reduction in VAT. "One Belt, One Road" initiatives conducted by the PRC government would introduce opportunities abroad to domestic contractors. Proportion of social security fund contribution for contractors lower to 16.0% would reduce their staff costs hence enhance profitability. Notwithstanding the potential upsides, HK-listed China based contractors are somewhat undervalued. As one of few sectors with high earning visibility, the construction sector as a whole is justified for rerating in our view.

Competitive edges

Sufficient human resources. Among its 6,738 full-time employees as of the end of 2018, 1,558 of them were first-class construction engineers, four of them won the title of "National Outstanding Project Manager and 27 were recognized as "Outstanding Project Manager in Hebei Province". In 2018, 360 of the group's employees passed the first-class registered architect examination.

Qualified for most types of projects. As of the end of June 2017, the group had one premium grade qualification, 19 first grade qualifications, 12 second grade qualifications and seven third grade qualifications. Its qualification cover 7 out of the 12 types of general contracting qualifications, and 17 out of the 36 types of specialized contracting qualifications in the construction contracting industry. With qualifications, the group is eligible to assume construction project of various kinds, covering residential, public, industrial and commercial buildings, municipal and transportation infrastructure such as ports and railways, as well as specialized construction projects such as electrical and mechanical installation and steel structure construction.

Rich intangible assets. Its profound history that can be traced back to the 50's and prestige for its superior craftmanship, innovation, excellency in project management as well as quality and safety control are valuable intangible assets which could not be quantified. Since its founded, the group has completed numerous landmark projects, which are the solid visual proof of its superior craftsmanship. It has been regular winner of awards in China construction industry and honored by various professional institutions/ governmental departments consistently. Its prestige, profound history, signature buildings and proven track record are competitive edges among its peers in winning project.

Innovation. The group had developed 105 national-level and provincial-level construction process methodologies, with some of them were recognized by MOHURD. In 2018, the group filed 99 patent applications in China, of which 28 were applications for invention patents. It was granted 78 patents, including 4 invention patents last year. It was accredited for 20 provincial-level key process technology. Besides, the group proactively participating in formulation of national standards for construction industry in China. In 2018, it participated in setting nine sets of regulations, standards and rules, and was in the process of preparing 26 sets of regulations, standards and rules for construction industry in China.

National network. The group has established national network consisted of 84 branch offices stretching across 31 provinces in China. Among its branches and subsidiaries, 61 were in BTH

Region while 23 were in other provinces. With national network, the group can bid/undertake projects anywhere in China. Besides, the group has been expanding its construction business abroad. With qualifications for provision of general contracting services to foreign aid projects and foreign labor service cooperation, the group has undertaken numerous projects in Angola, Laos, Fiji and Venezuela.

B2B platform. The group launched Yuncai Network, a B2B online procurement and outsourcing platform which connects it with construction contractors, suppliers as well as subcontractors in China, in November 2015. It is a centralized online platform which provides the group with access to broad range of suppliers and subcontractors, and intelligence regarding their capabilities and credibility, allowing the group to select the right business partners for projects, lower transaction and procurement costs and beef efficiency along its supply chain. Since April 2016, Yuncai has been the group's major channel for procurement of raw materials, outsourcing subcontracting services, as well as buying or leasing of equipment and machinery. Yuncai Network is the group's private online platform at this juncture. However, we are in the view that the platform has potential to be further developed into major B2B platform for construction industry in China.

Industry overview

Construction sector in 2018. In its report" Aspects of fixed assets investment in 2018 and outlook of fixed assets investment for 2019", NDRC revealed that number of state-approved FAI projects increased 15.5% YoY in 2018. Amid that, number of approved infrastructure projects increased 5.3% YoY. Among approved infrastructure projects, number of transportations, warehousing, postal, telecommunication and IT services related projects increased 4.4% YoY, while number of hydraulic, environmental and public utility projects increased 8.4% YoY.

Besides, total FAI of transportation reached CNY3,200b in 2018, of which, CNY802.8b, CNY2,300b and CNY81.0b were deployed in railway, waterway and expressway and civil aviation projects, respectively.

Total output value of construction industry increased 9.9% YoY to CNY23,508.6b in 2018. Building construction area expanded 6.9% YoY to 14.1b m^2. Total area of newly commenced construction projects increased by 17.2% YoY to about 2.1b m^2, of which area for newly commenced residential projects went up by 19.7% YoY. Meanwhile, lengths of railway, highspeed railway, expressway and rural road extended by 4,683km, 4,100km, 6,000km and above 300,000km, respectively.

Robust growth momentum in the industry till 2020. Output of China construction industry is projected to expand by 5.9% YoY and 6.1% YoY, respectively in 2019 and 2020, according to a report by Fitch Solutions, on expansion in FAI, in particular in railway related infrastructure and increase in construction spending for property development.

We expect output value of building construction sector to expand in 1Q 2019, due to number of approved property development projects increased 32.8% YoY in 4Q 2018 and contractors usually commence constructions in three months following approval granted, empirically.

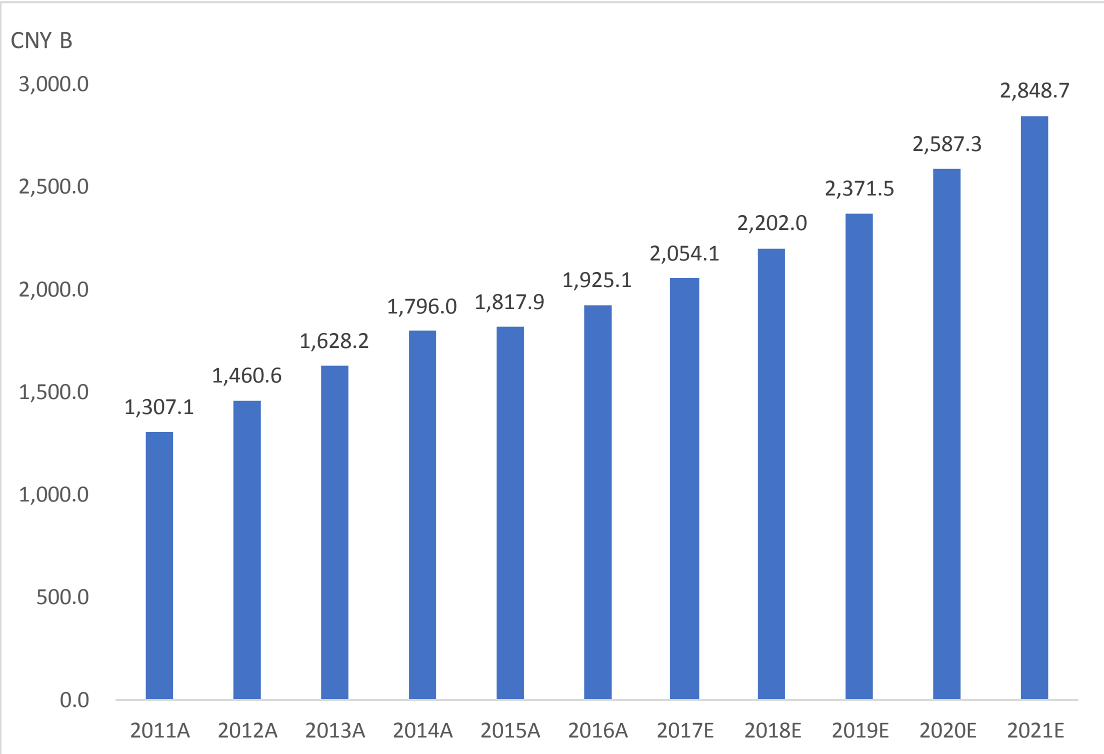
Infrastructure investment could increase by 5%-10% YoY in 2019, on inceptions of projects including hydraulic facilities, Sichuan-Tibet railway, intercity transportation network, logistic network, disaster prevention facilities and aviation. It was reported that CNY180b is set to be deployed in national transportation system to extend the length of rural road and inland waterway by 200,000.0km and 400.0km in this year.

China Railway Corporation revealed in January its plan to lay 6,800.0 km new railway track in 2019, representing a 45.2% leap from the length of railway constructed in last year, of which

3,200 km would be high-speed railway. Further, several urban and inter-city rail projects including those planned in Shanghai and Wuhan, worth CNY860.0b, have been approved by the government. New railway projects would boost FAI of railway sector by 6.0% and 6.5%, respectively in 2019 and 2020.

Benefit from regional construction boom. According to the data provided by National Bureau of Statistics of China and projection conducted by consulting and research institution, Frost & Sullivan, output value of construction industry in China grew at five-year CAGR of 10.7%, from CNY11,646.3b in 2011 to CNY19,356.7b in 2016. Meanwhile, output value of construction sector in BTH Region increased at five-year CAGR of 8.1%, from CNY1,307.1b in 2011 to 1,925.1b in 2016. Ongoing synergic development in BTH Region, continue urbanization in Baoding and the multitrillion Xiongan New Area development project are expected to boost the output value of regional construction industry from RMB2,202.0b for 2018F to 2,848.7b for 2021F, representing a three-year CAGR of 9.0%, outpacing three-year output value CAGR of 3.7% of China construction industry as a whole in the same period. As a leading non-state-owned contractor in the region, Hebei Construction is well positioned to benefit from the regional construction prosperity.

Chart 1: Output value of construction industry in BTH Region



Source: National Bureau of Statistics of China, Frost & Sullivan

Leading position in the region. Headquartered in Baoding, Hebei province, the pivot in the synergic development of BTH Region where Xiongan New Area is located, Hebei Construction has inherent geographic advantage among its peers in projects winning within the region. Its reputation and proven track record in the region, profound knowledge of the local market, broad customer base as well as established working relationship with local government in Baoding make it a tough match for other contractors to compete with in project bidding in the region. The group has already set up three JVs with the local government to undertake projects in Xiongan New Area.

Ready to reap a big chunk of multitrillion project. Frost & Sullivan estimated that fixed-assets investment relevant to the establishment of Xiongan New Area would exceed CNY400b between 2017 and 2021. In its article published on April 13th 2017, SCMP quoted projection from a multinational investment bank that theFAI for the development of Xiongan New Area could be in between US$173.4b and US$346.8b over the next decade, making it a largest infrastructure project in the history of modern China. Since Xiongan New Area is situated in the group's hometown, Baoding, the latter is expected to reap a large chunk of businesses from the multitrillion project among its peers on its first mover advantages.

Benefit from the urbanization in Hebei Province. Hebei province has the lowest urbanization rate in BTH region. In 2016, urbanization rate at Hebei Province was about 53.0%, substantially lower than that of 87.0% at Beijing, 83.0% at Tianjin, as well as the national average urbanization rate of 57.4%. Infrastructure and related public facilities at Hebei Province have been relatively obsoleted and insufficient, compared to that in Beijing and Tianjin. To cope with Beijing and Tianjin, infrastructures in Hebei province are needed to be revamped and upgraded. Frost & Sullivan expected that urbanization rate in BTH region as a whole and Hebei Province in particular to increase to 71.4% and 62.1%, respectively by 2021. Given the provincial urbanization, number and size of projects in Hebei are expected to increase. As a Baoding based major contractor in the region, the group is well positioned to benefit from the urbanization in Hebei Province.

Opportunities: The multitrillion Xiongan New Area projects

About BTH Region. Beijing-Tianjin-Hebei ("BTH") Region is the mega metropolis formed by Beijing, the capital city, Tianjin, the coastal metropolis of Bohai Gulf and Hebei Province. With population exceeds 100m people, the region covers 11 prefecture-level cities in Hebei Province including Baoding, Tangshan, Langfang, Shijiazhuang, Xingtai, Handan, Hengshui, Cangzhou, Qinhuangdao, Zhangjiakou and Chengde. In 2011 and 2016, nominal GDP of the region grew at five-year CAGR of 6.7%, from CNY5,207.5b to CNY7,206.4b; meanwhile, regional pre-capita GDP increased at five-year CAGR of 7.8%.

Synergic development in BTH Region. In 2011 the PRC government had proposed to enhance the economic synergy in BTH Region, and three years later, policies regarding the synergic development in BTH Region were orchestrated and implemented. Strategic purposes of policies included formation of new economic circle around Beijing, reallocation of some "non-political and capital" functions from Beijing to adjacent cities, and development of Bohai Rim Economic Zone, which covers Beijing and Tianjin, Hebei, Shanxi, Liaoning and Shandong provinces, the Inner Mongolia autonomous region and inland of the Northern China.

Blueprint of Xiongan New Area. Designated in April 2017, Xiongan New Area is designed to span Xiong, Rongcheng and Anxin counties in the groups' hometown, Baoding of Hebei Province, located about 100 km southwest of Beijing. In April 2018, the Central Committee of the Communist Party of China (CPC) and the State Council approved the masterplan of Xiongan New Area. Under which, Xiongan would be developed into a competitive, smart and green city by 2035. It would become a pivotal area in BTH Region, performing some of the non-capital functions for Beijing and absorbing population from the capital city.

30.0% of Xiongan' site area of 1,770.0 km², or 530.0 km² are dedicated for the development of smart and green city with low CO_2 emission, while green and forestry zone as well as Baiyangdian Lake would be reserved and expanded. Only advanced eco-friendly and energy saving construction materials and techniques would be adopted in the construction of the city. Digital infrastructure as well as advanced disaster-preventing facilities would be set up too. Six railway routes and four high speed rail station would be laid in order to connect Xiongan to Beijing, Tianjin and Shijiazhuang; and an airport would be built in the area.

Population in Xiongan is projected to exceed 6.7m a decade later, from about 1.04m currently;

though population density at Xiongan would be capped below 10,000 people per km². Diversified housing system would be developed to accommodate the expanding population; notwithstanding properties development in Xiongan is expected to be subject to close monitored and speculation activities in real estate market there would be restrained. Public facilities such as schools, hospitals, commercial and governmental complex would be erected too to cope with demand of dwellers there.

On the economic front, Xiongan New Area is designed as one of the major home bases for hi-end and hi-tech industries such as IT, biotechnology, new materials, as well as green agriculture and service industries. Heavy industries with high CO2 emission and energy consumption would be excluded from the area. Supportive policies would be implemented to complement the development of hi-tech industries there, and research institutions as well as universities would be set up in the area too to support the R&D of hi-tech industries.

Opportunities: PPP would broaden sources of revenue and secure project

Construction business model. The group currently conducts its construction business under the procurement construction contracting model, or "PC", construction contracting model, engineering, procurement and construction or EPC model, and Public-private partnership, or PPP model. Under the PC model, the group is responsible for the procurement of general equipment and materials for construction, and implement the construction plan, ensuring that is in line with owner's plan and schedule. Under the construction contracting model, general contractor or project owner subcontract portion of the project that requires specialized qualifications. Under the EPC model, the group provide contracting services for either the entire project or for certain stages in the project. The group is responsible to the project owner for the quality, safety and timely delivery and cost of the project.

PPP. Public-private partnership is a cooperation of the government and private sector on specific projects based on the framework agreement between the governmental entity and institution/individual from private sector. Under the PPP mode, a project company would be formed by the group alone, or jointly with local government and/or other private sector investor to act as investor and manager of the project, assuming responsibilities of financing, construction operation and management of the relevant PPP project. In case of the group is investor of the PPP project company, the latter usually subcontract the construction of the targeted projects to the group afterward. The project company also entitled to recurrent income from the operation of the relevant project in designated terms.

Additional sources of revenue. Being the investor of the PPP project ensuring the group secures the concerning project. Other than conventional construction revenue model resemble to the PC of BOT models, the group would receive recurrent income from project operation throughout the designated term of the project under the PPP mode. Hence, PPP mode will improve the group's revenue visibility and quality and broaden its sources of revenue by introducing recurrent income resembles to utility companies' into the group's revenue model.

Disclaimer

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