

# Taliworks Corporation

Recommendation: **BUY**

Stock Code: **8524**

Bloomberg: **CI MK**

Price: **MYR1.75**

12-Month Target Price: **MYR2.30**

Date: **April 10, 2008**

**Board:** Main

**Sector:** Trading/Services

**GICS:** Utilities/Water Utilities

**Market Value - Total:** MYR657.5 mln

**Summary:** Taliworks operates and maintains water treatment plants in Selangor and Langkawi, Kedah. In addition, it undertakes water related facility construction projects in Malaysia and waste management projects in China. The group has expanded its business into highway management (Cheras - Kajang Highway concession) in 2007.

**Analyst:** Chok Wai Lee, CFA



## Highlights

- Taliworks' net profit and cash flow are generally stable, derived predominantly from income received from its water treatment and supply businesses, and highway management division.
- In 2008, Taliworks' net profit is projected to rise 26.4% YoY due to the absence of exceptional charges that had dampened 2007 performance. In addition, we have factored in the first full year contribution from its highway management division. However, 2009 net profit is forecast to fall by 21.8% YoY as bulk of the construction order book will likely be completed by 2008.
- Going forward, the group will focus on growing its existing businesses through viable business ventures, specifically in the areas of water, toll road, construction, and waste management projects, both locally and abroad.

## Investment Risks

- Risks to our recommendation and target price include regulatory issues related to its concessions, that could lead to lower water tariffs or toll rates. Higher costs have been built into the concessions' pricing mechanism but there is no guarantee that Taliworks will be able to attain stated price increases and/or avert collection difficulties. We also notice that due to recent political changes, current weak sentiment for water related stocks may result in underperformance of Taliworks' share price. In addition, Taliworks' relatively low historical trading activity may be a risk.

## Recommendation

- We resume coverage on Taliworks with a Buy recommendation and a 12-month target price of MYR2.30. Our target price is determined based on discounted cash flows (DCF) analysis (WACC: 9.4%-10.6%, terminal growth: 3%). Our target price also includes a projected net DPS of 7.4 sen for the next 12 months.
- We refrain from prescribing a more aggressive recommendation on Taliworks' that would normally be warranted due to concerns over the susceptibility of earnings to lower water tariffs (due to renegotiation of concession agreements) and the current weak market sentiment towards water related stocks. However, we believe the risks should be largely reflected in Taliworks' share price, which has fallen 26.8% YTD.
- We think that fundamentals for Taliworks' remain intact, and recent weakness should present a buying opportunity for investors. We like Taliworks for its healthy balance sheet, stable positive cash flow and decent dividend yield of 5.7%. Taliworks targets to increase its revenue contribution from overseas ventures to 50% in three years' time (5% in 2007). In our view, this is a strategic move as it would reduce Taliworks' dependence on earnings from local water concessions and mitigate risks of lower water tariffs. The stock should receive a boost when it secures new projects that we have yet to reflect in our forecasts. We are positive on its recent expansion into highway management as this will provide another new steady and recurring earnings stream to Taliworks.
- Taliworks' 2006 annual report contained statements affirming its commitment to the framework on Corporate Social Responsibility.

### Key Stock Statistics

| FY Dec.                | 2007 | 2008E |
|------------------------|------|-------|
| Reported EPS (sen)     | 9.0  | 11.9  |
| PER (x)                | 19.5 | 14.7  |
| Dividend/Share (sen)   | 9.5  | 10.0  |
| NTA/Share (MYR)        | 0.83 | 0.88  |
| Book Value/Share (MYR) | 0.88 | 0.92  |

No. of Outstanding Shares (mln) **375.7**  
 52-week Share Price Range (MYR) **1.63 - 2.55**

Major Shareholders:  
 Lim Chee Meng and family **52.6**  
 Kumpulan Perangsang Selangor **19.8**

\*Stock deemed Shariah compliant by the Securities Commission.

### Per Share Data

| FY Dec.                 | 2005 | 2006 | 2007 | 2008E |
|-------------------------|------|------|------|-------|
| Book Value (MYR)        | 0.78 | 0.84 | 0.88 | 0.92  |
| Cash Flow (sen)         | 10.7 | 10.1 | 11.3 | 12.3  |
| Reported Earnings (sen) | 12.5 | 9.8  | 9.0  | 11.9  |
| Dividend (sen)          | 8.0  | 10.0 | 9.5  | 10.0  |
| Payout Ratio (%)        | 57.5 | 77.3 | 63.5 | 62.2  |
| PER (x)                 | 14.0 | 17.9 | 19.5 | 14.7  |
| P/Cash Flow (x)         | 16.4 | 17.3 | 15.5 | 14.2  |
| P/Book Value (x)        | 2.3  | 2.1  | 2.0  | 1.9   |
| Dividend Yield (%)      | 4.6  | 5.7  | 5.4  | 5.7   |
| ROE (%)                 | 13.8 | 11.8 | 12.8 | 13.2  |
| Net Gearing (%)         | 0.0  | 0.0  | 55.2 | 44.0  |

All required disclosures and analyst certification appear on the last two pages of this report. Additional information is available upon request.

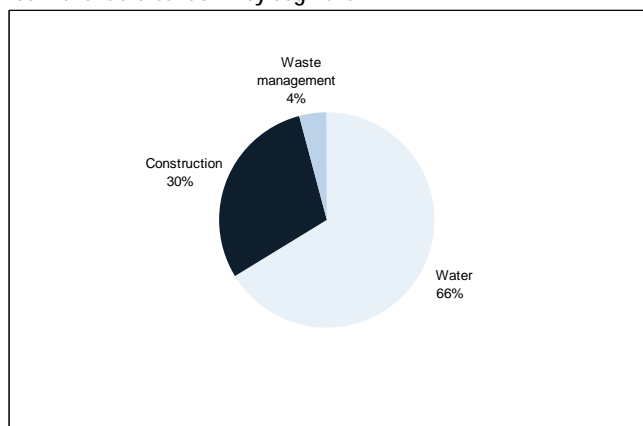
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Page 1 of 5

## Business

Taliworks was listed on the Main Board of the Bursa Malaysia in Oct. 2000 through the reverse take over of Carpets International. It has been involved in water supply privatisations since 1987 and currently operates and maintains six water treatment plants in Selangor and Langkawi, Kedah, with a combined capacity of 1,039.5 mld litres/day (mld). Taliworks also undertakes water-related construction projects. The group has ventured into waste management projects in China. Recently, it has expanded its business into highway management (Cheras - Kajang Highway concession).

### 2007 revenue breakdown by segment



Source: Company data

### Water

Taliworks is the operation & maintenance (O&M) contractor for the Sungai Selangor Treatment Works Phase 1 (SSP1). The O&M agreement stretches to 2030. SSP1, with a treatment capacity of 950 mld, supplies water to Selangor and Kuala Lumpur at a bulk sale rate (BSR) of MYR0.35/m<sup>3</sup>. Costs associated with the treatment of water, mainly chemicals and utilities, and the maintenance costs are taken into consideration through a step-up pricing mechanism.

The Langkawi concession, undertaken by Taliworks (Langkawi), involves management of four water treatment plants in Langkawi and one in Perlis, as well as the maintenance of 517km of water pipes linking Perlis to Langkawi. This concession will expire in 2020. Similar to SSP1, there is a step-up mechanism to allow for facility upgrades while operating costs are largely factored in current pricing. The current BSR for the project is MYR1.92/m<sup>3</sup>.

In 2007, these two concessions sold 772 mld, with SSP1 making up the lion's share at 730 mld.

### Construction

The construction division was formed in Sep. 2006, following the award of the MYR149 mln Padang Terap Water Supply Project in Kedah to the group in Aug. 2006. The project is scheduled for completion by Feb. 2009. Besides, Taliworks also secured a MYR22 mln sub-contract for flood mitigation works in the Klang Valley in Sep. 2007. The project is scheduled to be completed by Sep. 2008.

Going forward, management is not expecting any new construction projects in near term as the main focus for Taliworks is to expand its other businesses which have more stable and recurring earnings streams.

### Waste management

Taliworks has concession rights to manage a transfer station in Tianjin, China (a major metropolis near Beijing), which involves the sorting and transfer of solid waste to landfills. We expect Taliworks to generate revenue of around MYR8-9 mln from this project based on estimated waste to be handled of at least 800 tons/day, at a fee of about CNY50/ton. Upside will come from targeted efficiency gains with management hoping to sort and transfer up to 1,200 tons/day of solid waste. The group has a 90% stake in the concession with the 10% minority being the city government. The takeover of this transfer stations commenced in 1Q05.

In addition, Taliworks has a 56% effective stake in Puresino (Guanghan) Ltd, which holds a 30-year concession for the 50 mld GuangHan San Xin Dui Wastewater Treatment Plant in Sichuan, China. The said concession will expire on Jul. 31, 2033 and it commenced commercial operations in Sep. 2007.

Taliworks also entered into a joint venture in Jun. 2007 to set up a production facility to produce and market CK21 bacteria and related products for wastewater sludge treatment in China. There are more than 700 wastewater treatment plants in China, which process approximately 50 mln tonnes of wastewater per day. In our view, the joint venture is still in its infancy, but will provide new business opportunities for Taliworks. This joint venture is expected to have good potential in Malaysia and other Association of Southeast Asian Nations (ASEAN) countries.

In our view, Taliworks' China projects are relatively new and we do not expect significant contributions from them in the near term.

### Highway Management

The group has expanded its business into highway management via the acquisition of a 55% stake in Cerah Sama Sdn Bhd (CSSB) in 2007. CSSB is the holding company of Grand Saga Sdn Bhd (GS, the toll operator of Cheras-Kajang Highway) and Trupadu Sdn Bhd (the O&M sub-contractor for GS). We are positive on the acquisition as this will provide another steady and recurring earnings stream to Taliworks. Earnings from CSSB will be equity accounted.

GS operates the 11.5km Cheras-Kajang Highway under a concession agreement with the government, which last till Sep. 2027. The tolling commenced on Jan. 1999 and the toll rates will be revised once every 6 years. The latest revision was in 2007. Currently, GS is profitable with growing traffic flows stem from developed townships.

The South East Asian Strategic Assets Fund (SEASAF) is another major shareholder of CSSB (holds 35% stake). It is a private equity fund, jointly sponsored by CIMB Group Sdn Bhd and Standard Bank Plc, and co-sponsored by the Employees Provident Fund of Malaysia to provide equity to commercially viable private sector ventures in the infrastructure, energy and natural resources sectors and their associated industries in the ASEAN region.

Going forward, in partnership with SEASAF, Taliworks will position CSSB as the flagship vehicle to engage in the business of developing and operating toll roads in Malaysia and the ASEAN region. Besides, Taliworks intends to list CSSB within 7 years after its acquisition.

In order to strengthen its balance sheet, Taliworks issued MYR225 mln of convertible bonds (CB) in 2007. The CB will mature in 5 years and comes with a coupon of 2.25% and conversion price of MYR2.50 (convertible into 90 mln of Taliworks shares).

Although the issuance of CB will increase the interest expenses for Taliworks, we think this is a strategic move as it will enhance the capability of the group to grow its existing businesses through viable business ventures, specifically in the areas of water, toll road, construction, and waste management projects, both locally and abroad. Currently, Taliworks is pursuing about MYR500 mln of water related projects in Malaysia and about MYR1 bln worth of overseas projects in water- and waste-related sectors.

## Earnings Outlook

Taliworks' net profit in 2007 fell 5.3% YoY to MYR33.7 mln mainly due to exceptional charges of MYR6.2 mln (MYR2.9 mln due to option expenses and MYR3.3 mln in relation to the CB and acquisition of CSSB). In addition, SSP1 recorded lower water production (-9% YoY) due to the continued rationalization of water supplies by SYABAS.

However, Taliworks' 2008 net profit is projected to rise 32.6% YoY to MYR44.7 mln due to the absence of exceptional charges that had dampened 2007 performance. In addition, we have factored in the first full year contribution from its highway management division. Water output for SSP1 is expected to be flat at 730 mld and we have taken into account the higher interest expenses from the CB.

2009 net profit is forecasted to fall by 20.6% YoY to MYR35.5 mln as bulk of the construction order book is completed in 2008. Nonetheless, in absence of the lower margin construction projects, Taliworks' operating margin is expected to rise to 36.9% in 2009 from 27.6% in 2008. We also expect water sales for SSP1 to increase by 3% YoY to 752 mld in 2009, following the completion of the rationalization of water supplies by SYABAS. We are not overly concern on Taliworks' depleting construction order book as Taliworks is actively bidding for new projects in other businesses, especially in the water and waste related sectors, both locally and abroad. This should mitigate the impact of lower contribution from the construction activities going forward. Taliworks targets to increase its revenue contribution from overseas ventures to 50% in three years' time vs. 5% in 2007. We have not factored in any new projects in our earnings model. Nonetheless, we think this is a strategic move as it would reduce Taliworks' dependence on earnings from local water concessions.

Due to the recent political changes, there has been speculation that the Selangor state government could look to review the agreement governing the water concessions in the state. However, we understand that only the National Water Services Commission (SPAN, which is under the purview of the Federal Government), has the mandate to set standards for all water service providers, such as approving capital expenditure and changes in tariff rates. In our view, although the concession agreements may have renegotiation risk, we believe that the new terms should be no less favorable than existing terms, if it happens. Lower water tariffs could come with compensation in various means, i.e. subsidies and extended concession periods. That said, we notice that the political uncertainties may cloud investors' sentiment on water related stocks, which result in underperformance of Taliworks' share price.

## Valuation

Our 12-month target price of MYR2.30 is based on DCF valuation (WACC: 9.4%-10.6%, terminal growth: 3%). Our target price also includes a projected net DPS of 7.4 sen for the next twelve months. We believe DCF valuation is ideal for Taliworks given its stable and relatively transparent cash flow stream. We have not factored in any construction based earnings in our model beyond 2009.

We refrain from prescribing a more aggressive recommendation on Taliworks' that would normally be warranted due to concerns over the susceptibility of earnings to lower water tariffs (due to renegotiation of concession agreements) and the current weak market sentiment towards water related stocks. However, we believe the risks should be largely reflected in Taliworks' share price, which has fallen 26.8% YTD.

Trading at 14.7x FY08 PER, Taliworks' valuation is not excessive compare with its peers, which trade around 14.5x. The current valuation is at the mid point of its historical trading range.

We think that fundamentals for Taliworks' remain intact, and recent weakness should present a buying opportunity for investors. We expect the share price to be well supported given its healthy financial position, stable positive cash flow and attractive dividend yield of 5.7%. In our view, 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                | 142.9 | 191.0 | 246.1 | 155.3 |
| Reported Operating Profit       | 47.4  | 52.4  | 68.0  | 57.2  |
| Depreciation & Amortization     | -2.2  | -1.5  | -1.5  | -1.6  |
| Net Interest Income / (Expense) | 2.0   | 0.6   | -5.9  | -8.4  |
| Reported Pre-tax Profit         | 50.3  | 46.7  | 62.7  | 49.5  |
| Effective Tax Rate (%)          | 29.2  | 29.0  | 28.4  | 27.7  |
| Reported Net Profit             | 35.7  | 33.7  | 44.7  | 35.5  |
| Reported Operating Margin (%)   | 33.1  | 27.4  | 27.6  | 36.9  |
| Reported Pre-tax Margin (%)     | 35.2  | 24.4  | 25.5  | 31.9  |
| Reported Net Margin (%)         | 25.0  | 17.7  | 18.2  | 22.8  |

Source: Company data, S&P Equity Research

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**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            | 2.30         |
| 10-Sep-07 | Hold           | 2.10         |
| 1-Mar-07  | Hold           | 1.80         |
| 1-Sep-06  | Hold           | 1.75         |
| 1-Jun-06  | Buy            | 1.56         |
| 16-May-06 | Hold           | 1.56         |
| 23-Nov-05 | Hold           | 1.45         |
| 15-Sep-05 | Hold           | 1.32         |

