

Guangdong Investment (270 HK)

Accumulate (initiation)

Target price: HK\$12.00

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Cash is king; initiate with Accumulate and TP of HK\$12.0

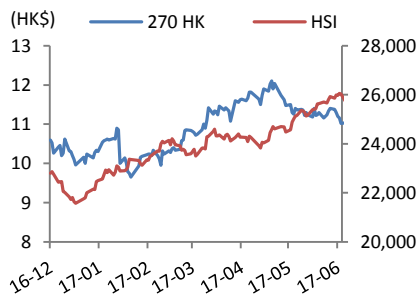
Defensive water business Around 62% of GDI's total revenue and approximately 63% of its operating profit are generated from its water business. The Dongshen water supply project, which supplies raw Dongjiang water to Hong Kong, Shenzhen and Dongguan, contributed approximately 87% of GDI's water segment revenue as well as 54% and 57% of company's total revenue and pretax profit in 2016. We expect Dongshen project's business model with three-year predetermined revenues to continue, with project revenue to grow 3% per annum during 2018-2020 as the company has the pricing power to achieve a material tariff hike. In addition, we expect the project's pretax margin to increase further by 2pp to 60% in 2020, boosted by improved operating efficiency and better cost control, to contribute ~57% of company's total pretax profit.

We think GDI is well positioned to capture opportunities arising from the accelerating introduction of PPP projects in China, given its: 1) strong net cash position and FCF, **2)** track record of integrated experience in water, tap water and sewage treatment, as well as road construction and operation, and **3)** favorable SOE background. So far, the company has secured PPP projects worth a total of HK\$6.4bn, mainly involving the construction and operation of A-grade highways and sewage treatment facilities in Hainan and Guangdong province. Among them, we like the Dongguan PPP project most, which is expected to start partial operation on its phase I in mid-2017 and generate stable cash inflow for GDI. According to management, the IRR for all of these PPP projects could eventually reach 10%, which would be 2pp higher than the current level and thus gradually drive GDI's EPS to a peak when all of the HK\$6.4bn is invested by the end of 2020. In the long run, we expect PPP projects along with M&A to fuel the company's capacity expansion and boost its bottom line.

As our favorite dividend yield play, We expect GDI's DPS to grow at a CAGR of 6% during 2016-2020, suggesting a further improvement in its dividend payout ratio of 7pp annually, supported by steady growth in recurring FCF. We expect the company's FCF per share to remain greater than its EPS by growing 3% per annum during 2016-2020, as substantial non-cash items such as depreciation and amortization need to be subtracted when calculating EPS. **The current stock price implies an 8.8%-9.4% FCF yield and a 4.1%-4.8% dividend yield, which are very attractive to us.**

Initiate with Accumulate and TP of HK\$12.0, implying 16x/15x 2018/19E P/E. The stock is currently trading at 14.6x/14.3x 2018/19E P/E, higher than the industry average. **We believe GDI deserves a premium given its defensive business nature**, which is firmly backed by: **1)** a highest dividend yield of 4.1%-4.8% among peers; **2)** its strong balance sheet with a net cash position of HK\$1.17bn; **3)** a healthy debt servicing position with an EBITDA interest coverage of 54.47x at end-2016; **4)** robust cash flow with an 8.8%-9.4% FCF yield; and **5)** low vulnerability to exchange rate fluctuations.

Stock performance



Source: Bloomberg

Key data

Jul 20 close (HK\$)	11.12
Shares in issue (m)	6,540
Major shareholder	GDH (45.4%)
Market cap (HK\$ bn)	72.7
3M avg. vol. (m)	5.4
52W high/low (HK\$)	9.41/13.00

Source: Bloomberg

Stock valuation

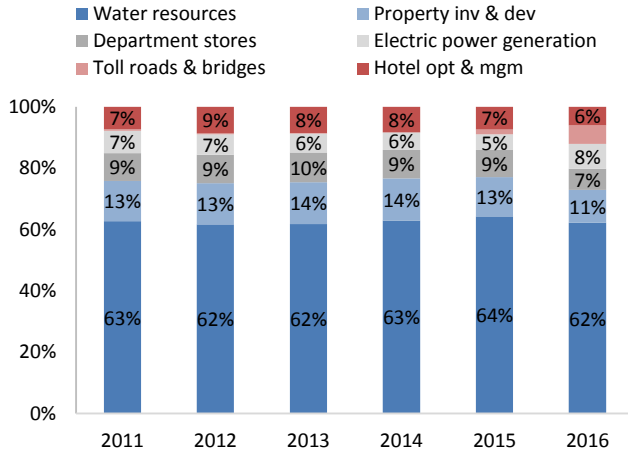
	Turnover (HK\$ m)	Net profit (HK\$ m)	EPS (HK\$)	EPS YoY (%)	P/E (x)	BPS (HK\$)	P/B (x)	ROE (%)	Dvd yield (%)
2015	9,172	3,905	0.62	-11%	17.8	1.81	6.1	12.4%	3.2%
2016	10,464	4,212	0.67	8%	16.5	1.85	6.0	13.1%	4.1%
2017E	11,322	4,745	0.73	8%	15.3	2.19	5.1	13.7%	4.1%
2018E	11,845	4,964	0.76	5%	14.6	2.57	4.3	13.6%	4.4%
2019E	12,226	5,091	0.78	3%	14.3	3.02	3.7	13.2%	4.8%

Sources: Company data, GF Securities (Hong Kong)

Defensive water business

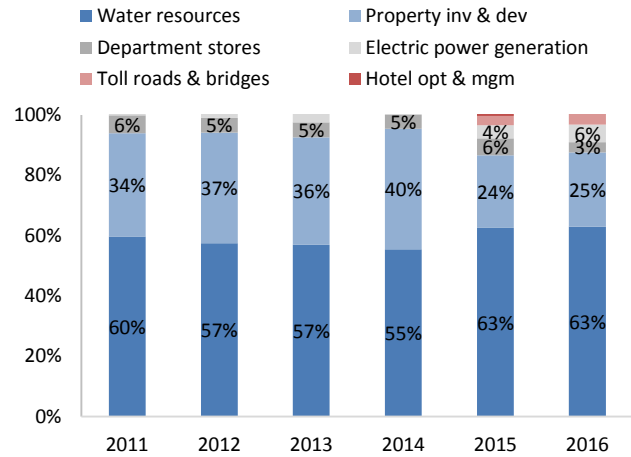
Main profit contributor As parent company GDH's only water-related business platform, **around 62% of GDI's total revenue and approximately 63% of its operating profit are generated from its water business.** The Dongshen water supply project, which supplies raw Dongjiang water to Hong Kong, Shenzhen and Dongguan, contributed approximately 87% of GDI's water segment revenue as well as 54% and 57% of company's total revenue and pretax profit in 2016.

Figure 1: GDI revenue breakdown



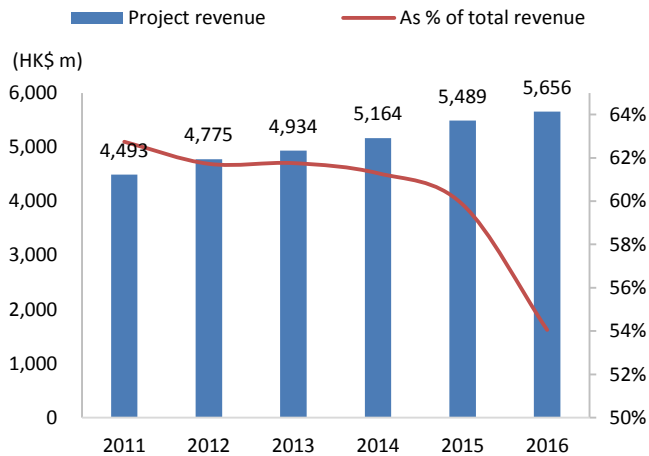
Sources: Company data, GF Securities (Hong Kong)

Figure 2: GDI operating profit breakdown



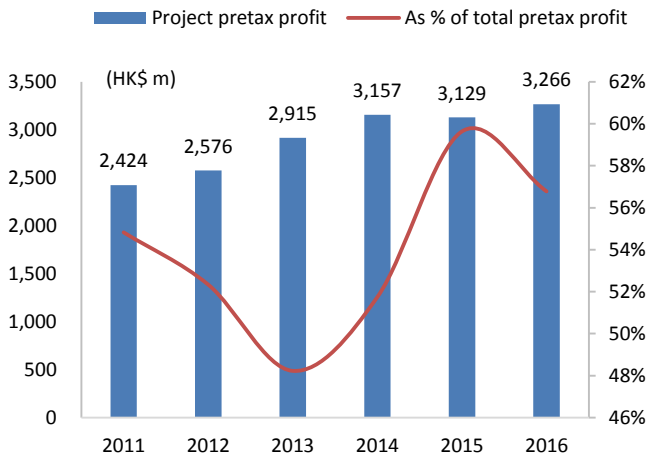
Sources: Company data, GF Securities (Hong Kong)

Figure 3: Revenue of Dongshen water supply project



Sources: Company data, GF Securities (Hong Kong)

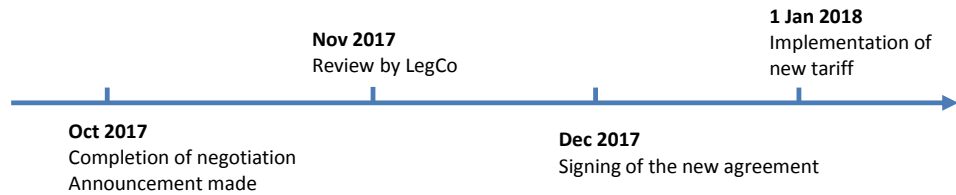
Figure 4: Pretax profit of Dongshen water supply project



Sources: Company data, GF Securities (Hong Kong)

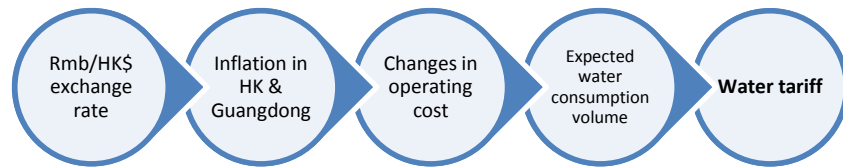
Dongshen water supply project: Starting from 2000, GDI has received lump-sum payments from the Hong Kong government under a 30-year concession agreement regardless of the actual volume of water supplied. The contract is renewed by the Hong Kong government and Guangdong provincial government every three years, taking into account the Rmb/HK\$ exchange rate, inflation rates in both cities, changes in operating cost and expected water consumption volume. The current term of the agreement (2015-2017) will end this year. According to past experience, the two governments will start discussions on the new water supply contract in the second half of this year and come to an agreement around Oct 2017. Afterwards, the Hong Kong Legislative Council (LegCo) will review the agreement as part of the government's annual fiscal budget in Nov before a final contract is signed in Dec.

Figure 5: Expected timeline for contract renewal



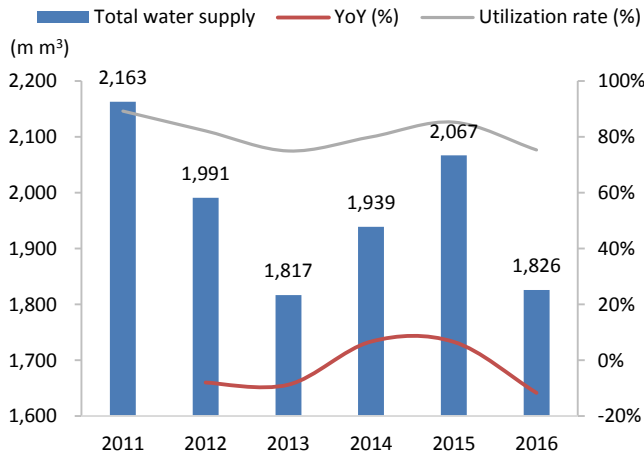
Sources: Company data, GF Securities (Hong Kong)

Figure 6: Factors for consideration in contract renewal negotiation



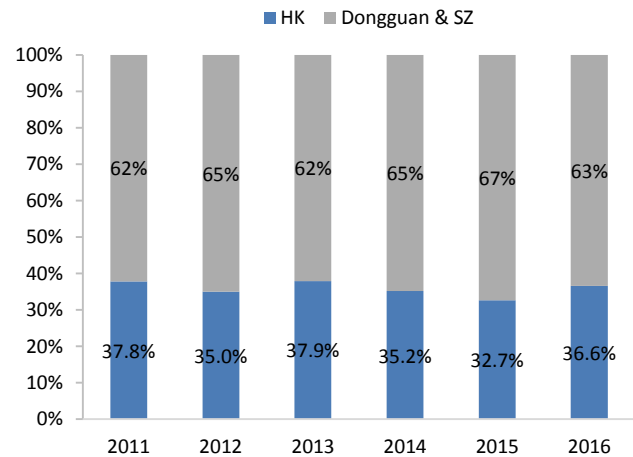
Sources: Company data, GF Securities (Hong Kong)

Figure 7: Total water supply of Dongshen project



Sources: Company data, GF Securities (Hong Kong)

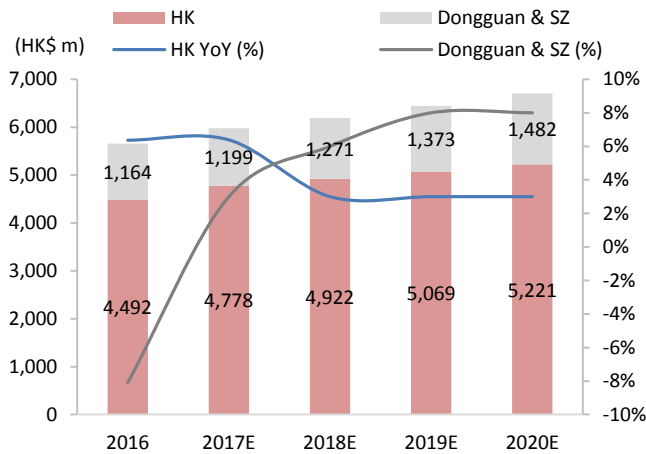
Figure 8: Geographical breakdown of water supply under Dongshen project



Sources: Company data, GF Securities (Hong Kong)

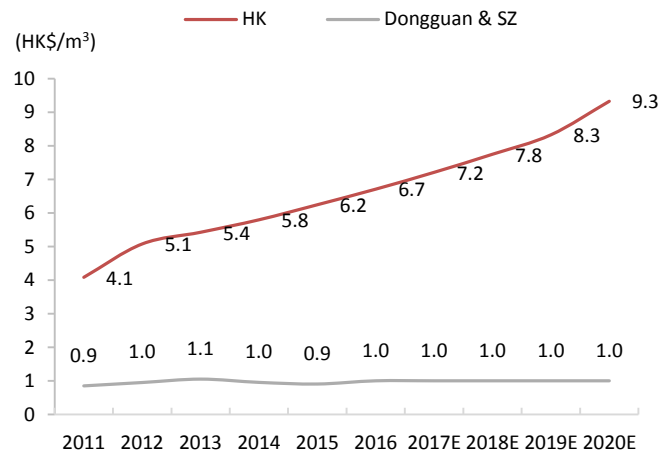
We expect this business model with three-year predetermined revenues to continue, but believe that revenue will grow at a slower pace of 3% per annum during 2018-2020 vs. 6.7%/6.4%/6.4% YoY agreed for 2015/16/17. The slowdown is mainly due to: 1) a dim outlook for Rmb appreciation; 2) the persistence of low inflation in Hong Kong; and 3) declining operating cost thanks to improved utilization and higher efficiency. However, management believes revenue is unlikely to remain flat in 2018-2020 as revenue from Dongshen water supply to Hong Kong has never declined in the past.

Figure 9: Dongshen project revenue estimates



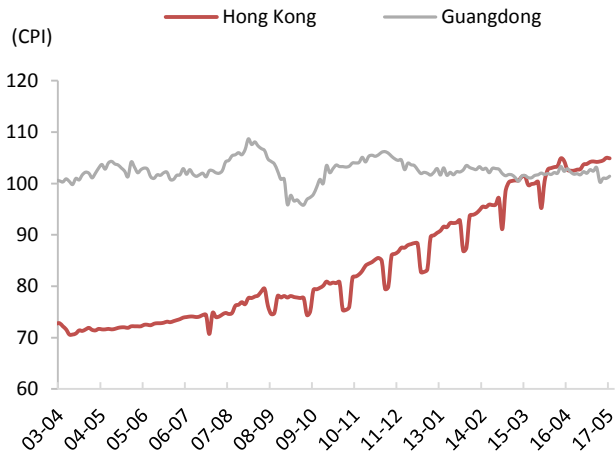
Sources: Company data, GF Securities (Hong Kong)

Figure 10: Implied water tariff



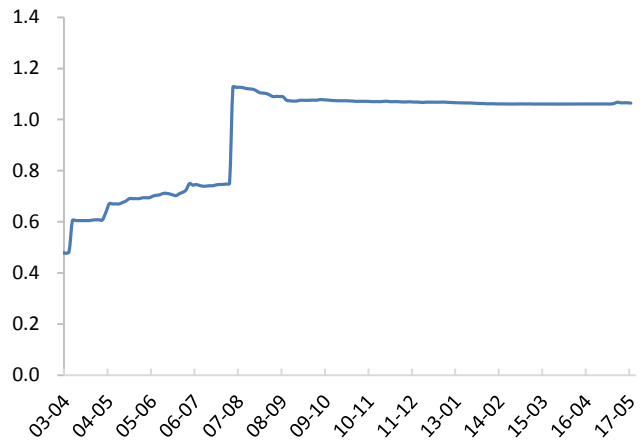
Sources: Company data, GF Securities (Hong Kong)

Figure 11: Inflation rates in HK & Guangdong



Sources: Wind, GF Securities (Hong Kong)

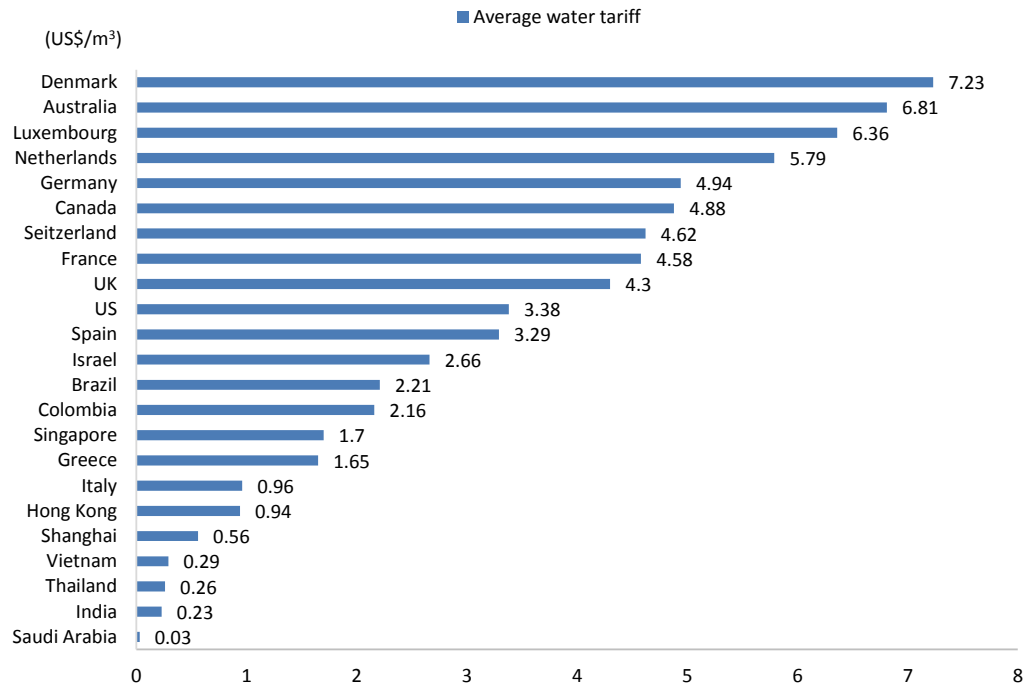
Figure 12: Rmb/HK\$ exchange rate



Sources: Wind, GF Securities (Hong Kong)

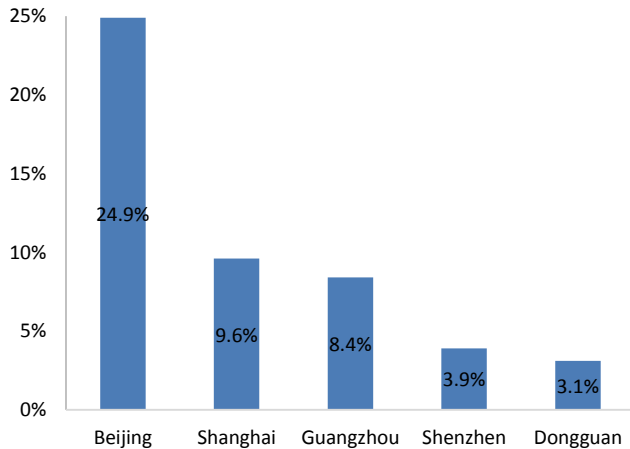
GDI has the pricing power to achieve a material tariff hike for the following reasons. First, water tariff growth in Hong Kong is much slower than that in peer cities, especially first-tier cities in China such as Beijing, Shanghai and Shenzhen which have already experienced several rounds of tariff hikes in recent years. For instance, water tariffs in Beijing grew at a CAGR of 24.9% during 2009-2014 to Rmb9/m³. Considering the higher living standards and wage levels in Hong Kong, we think the city's government will accept a higher water purchase cost and pass the tariff increase on to end users in the city.

Figure 13: Comparison of average water tariff among different countries



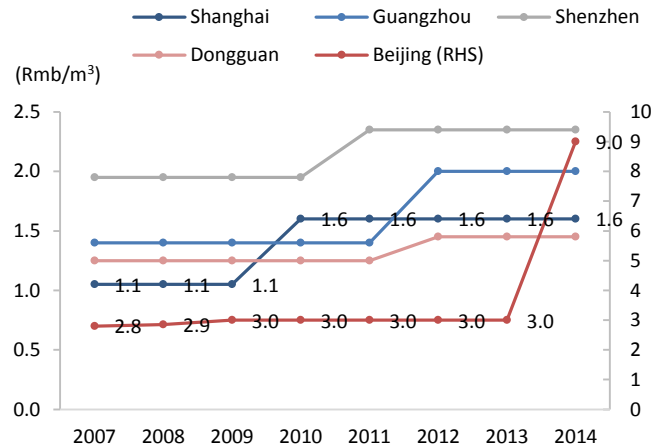
Sources: E20, GF Securities (Hong Kong)

Figure 14: 2009-2014 water tariff CAGR in China's major cities



Sources: E20, GF Securities (Hong Kong)

Figure 15: Rising trends of water supply tariff in major China cities since 2007



Sources: E20, GF Securities (Hong Kong)

Second, Hong Kong's demand for Dongjiang water is believed to be resilient, as nearly 75% of the city's water supply relies on it, and there are no cost-effective alternative sources of raw water supply. According to the Hong Kong government's long-term estimates, the city's annual fresh water consumption should increase ~40% from 959m³ in 2014 to 1,315m³ by 2030. Therefore, an upward revision to the annual supply volume cap from the current 820m³ to 1,100m³ is possible in our view, though we have not included this into our forecast model.

Figure 16: Breakdown of HK's water supply

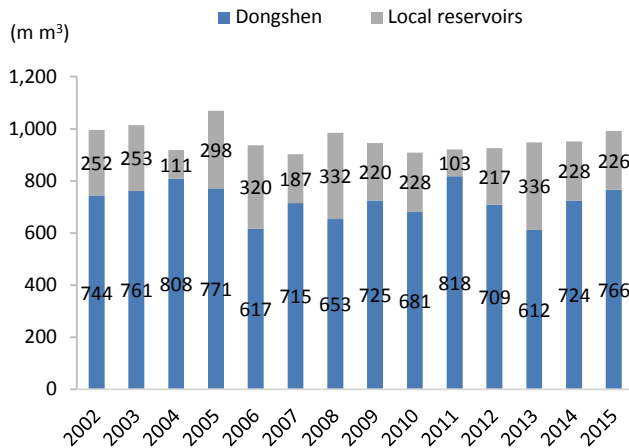
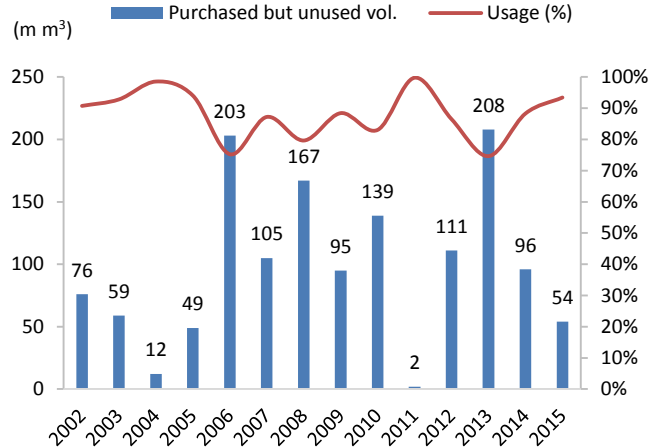


Figure 17: High utilization of water purchased



Sources: Water Supplies Department, Company Data, GF Securities (Hong Kong)

Figure 18: Historical precipitation in Hong Kong

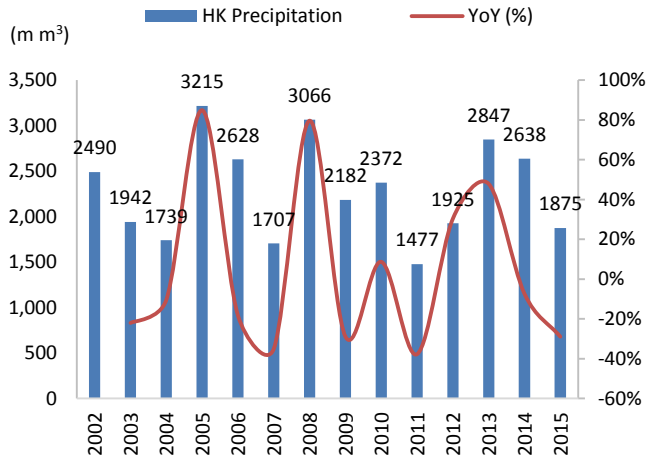
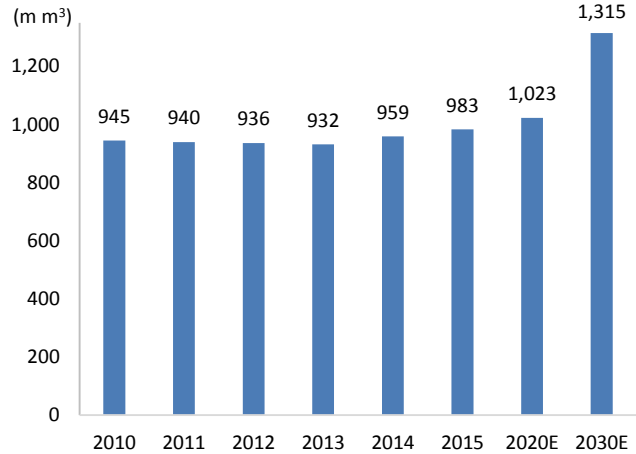


Figure 19: Hong Kong water demand forecast

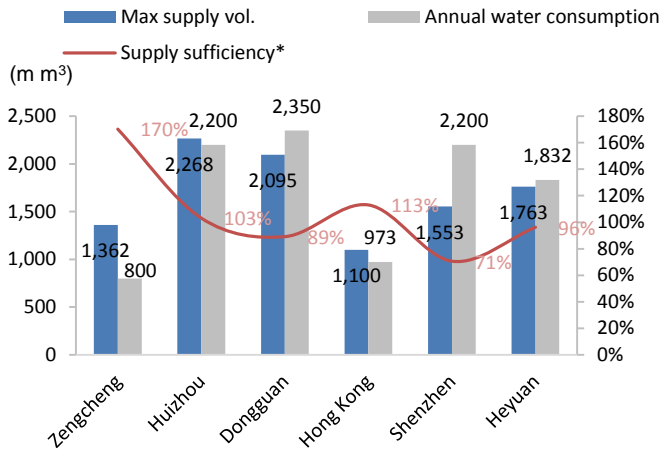


Sources: Water Supplies Department, GF Securities (Hong Kong)

Sources: Water Supplies Department, GF Securities (Hong Kong)

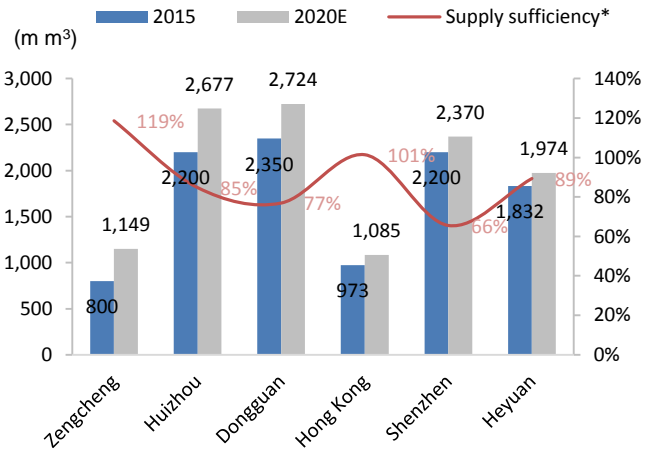
Third, the competition for Dongjiang water is increasingly fierce among cities near the river due to accelerating economic development and recovering industrial activities. Currently, Dongjiang accounts for more than 50% and 80% of water supply to Shenzhen and eight other riverside cities. According to the Water Resources Department of Guangdong province, the annual average water flow of Dongjiang over the past three years was 25.4bn m³, 23% lower than the historical average of 33.1bn m³ during 1956-2005. In comparison, the annual consumption of raw water from Dongjiang by residents in Hong Kong and eight key cities in Guangdong amounts to over 10bn m³, suggesting an increasing possibility of water shortage in the near future.

Figure 20: Supply and demand of raw water from Dongjiang (2015)



Sources: Water Supplies Department, GF Securities (Hong Kong)
 Note: *Supply sufficiency = max supply / consumption

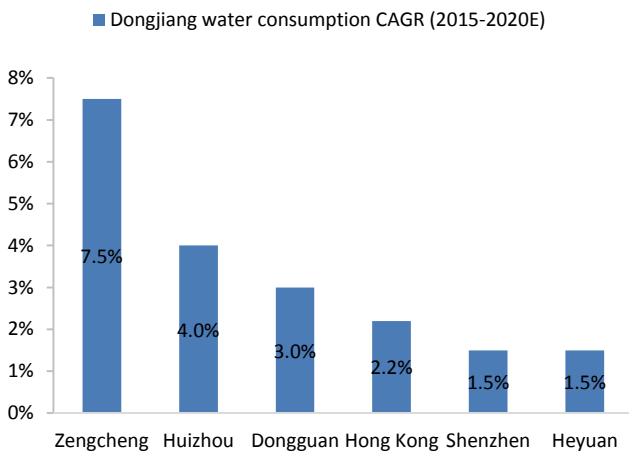
Figure 21: Forecasts of Dongjiang water consumption (2020E)



Sources: Water Supplies Department, GF Securities (Hong Kong)
 Note: *Supply sufficiency = max supply / consumption

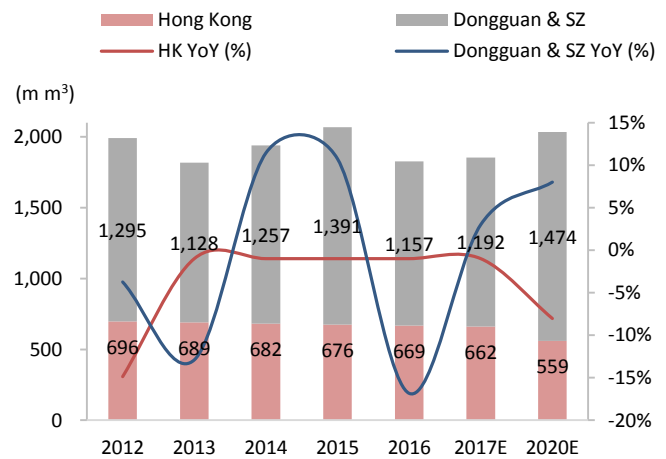
We expect to see a water supply shortage in the southern Guangdong region in 2020E where raw water supply from Dongjiang will meet just ~85% of the water consumption needs of nearby cities including Hong Kong. Therefore, we expect the Hong Kong government to play safe and buy itself some insurance in case water supply from local reservoirs is lower than expected. However, annual water supply to Hong Kong under the Dongshen project is expected to decline at an average pace of 4.4% YoY during 2016-2020 due to increasingly scarce water resources in Guangdong province. In contrast, water supply to Dongguan & Shenzhen from the project will jump 27% during the same period.

Figure 22: Consumption of raw water from Dongjiang to increase at ~3% CAGR in 2015-2020E



Sources: Water Supplies Department, GF Securities (Hong Kong)

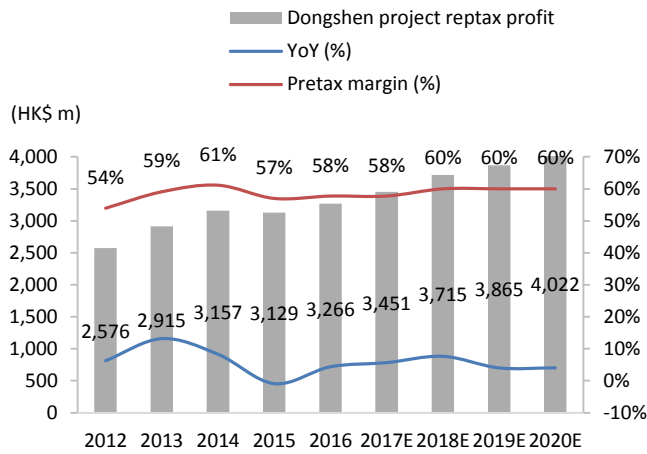
Figure 23: Forecasts of raw water supply from Dongjiang in 2020E



Sources: Water Supplies Department, GF Securities (Hong Kong)

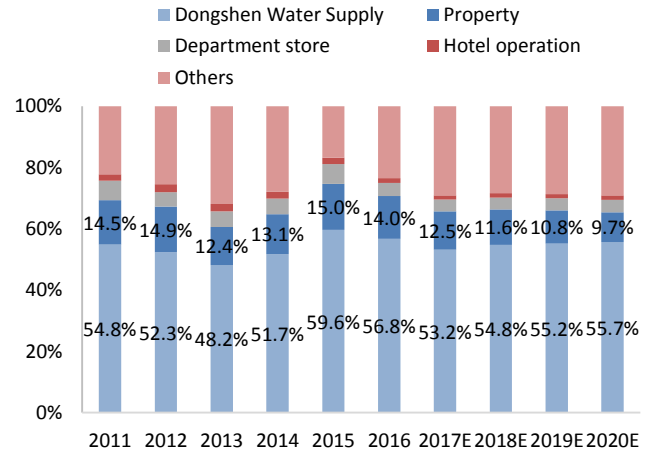
Thanks to the advantages of supplying water to Hong Kong, the pretax margin of the Dongshen project has remained above 55% over the years. We expect the pretax margin of the project to further increase 2pp from 2016 to 60% in 2020, driven by improved operating efficiency and better cost control, contributing ~57% of the company's total pretax profit.

Figure 24: Improving pretax margin of Dongshen project



Sources: Company data, GF Securities (Hong Kong)

Figure 25: ~57% pretax profit contribution from Dongshen project



Sources: Company data, GF Securities (Hong Kong)

Beneficiary of PPP projects

We think GDI is well positioned to capture opportunities arising from the accelerating roll-out of PPP projects in China, given its: 1) strong net cash position and free cash flow (FCF), 2) track record of integrated experience in water, tap water and sewage treatment, as well as road construction and operation, and 3) favorable SOE background.

So far, the company has secured PPP projects worth a total of HK\$6.4bn, mainly involving the construction and operation of A-grade highways and sewage treatment facilities in Hainan and Guangdong province. According to the company, the targeted ROI of its PPP projects is around 8%. Among them, the flagship Dongguan PPP project is expected to start partial operation on its phase I in mid-2017 and generate stable cash inflow for GDI.

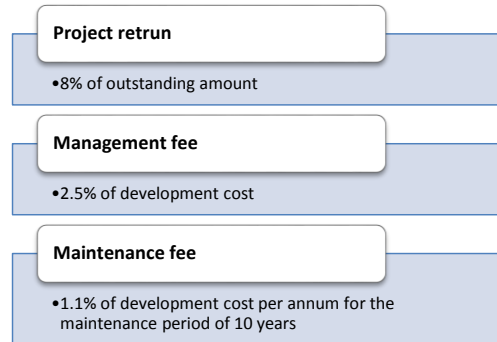
Figure 26: PPP projects secured in 2016-2017

Project	Date	City	Investment (HK\$ m)	Water supply ('000 tpd)	Sewage treatment ('000 tpd)	Details
Dongguan Project	Jun-16	Yinping Innovation Zone, Xiegang, Dongguan	5,614	N/A	N/A	Construction of A-grade highways, connecting roads and municipal roads, and related ancillary services such as drainage, greening and lighting
Binhai Water Project	Sep-16	Binhai District, Danzhou, Hainan	500	100	80	Construction and operation of water supply & sewage treatment plants and relevant facilities
Zhanjiang Suixi Water Project	Sep-16	Suixi County, Zhanjiang City, Guangdong	140	60	30	Investment in and operation of a water supply plant in the city. Investment, construction and operation of supporting water supply plant in Lingbei Industrial Park, and commissioned operation of Lingbei sewage treatment plant
Gaozhou Water Project	Jan-17	Gaozhou, Guangdong	492	200	N/A	Investment in, construction, operation and maintenance of the second water plant supplying water to the urban area and suburbs of Gaozhou
Wuhua Sewage Water Project	Apr-17	Wuhua County, Meizhou, Guangdong	188	N/A	10	Development of town-level sewage treatment facilities and ancillary pipeline networks
Total			6,442	160	120	

Sources: Company data, GF Securities (Hong Kong)

We like this particular project for several reasons. First of all, the ceiling on the project development cost budget avoids the risk of cost overrun by giving GDI the right to stop investing when total project cost goes over Rmb4,754m (~HK\$5,614m). Second, it is a multi-year engagement with separate budgets for each phase and the development cost paid in ten annual instalments by the Xiegang government, which minimizes payment collection risk. Third, it is a long-term PPP project delivering steady returns through an accrued interest (8%), management fee (2.5%) and maintenance fee (1.1%). In addition, we expect GDI to reinvest part of the return from the earlier phases in the later stage of the project, which means that total cash outflow for the entire project will be smaller than the planned capex. Lastly, there is no construction risk as the construction work will be completed by contractors.

Figure 27: Three sources of income for Dongguan project



Sources: Company data, GF Securities (Hong Kong)

According to management, the IRR for all of these PPP projects could eventually reach 10%, which would be 2pp higher than the current level and thus gradually drive GDI’s EPS to a peak when all of the HK\$6.4bn is invested by the end of 2020. In the long run, we expect PPP projects along with M&A to fuel the company’s capacity expansion and boost its bottom line.

According to management, GDI will focus on PPP projects in Guangdong, where the local government has a steady financial base and minimal payment default risk. To avoid potential competition, GDI also carefully reviews government construction plans and potential budget control risks. For example, GDI had evaluated and analyzed the local government’s development plans for the Xingliu Expressway and Dongguan project before signing the contacts.

More M&A to come

Thanks to its strong balance sheet and net cash of HK\$1.17bn, GDI’s strategy to focus on PRC water project acquisition is likely to accelerate and boost capacity addition over the next two years. In addition to the Dongshen water supply project, GDI operates 15 water projects with total water supply capacity of 2.44m tpd and sewage treatment capacity of 393k tpd through its wholly-owned subsidiary Water Group HK. 14 of the 15 projects were acquired from a third party or GDI’s parent company, mostly at a discount and fully funded by cash and internal resources.

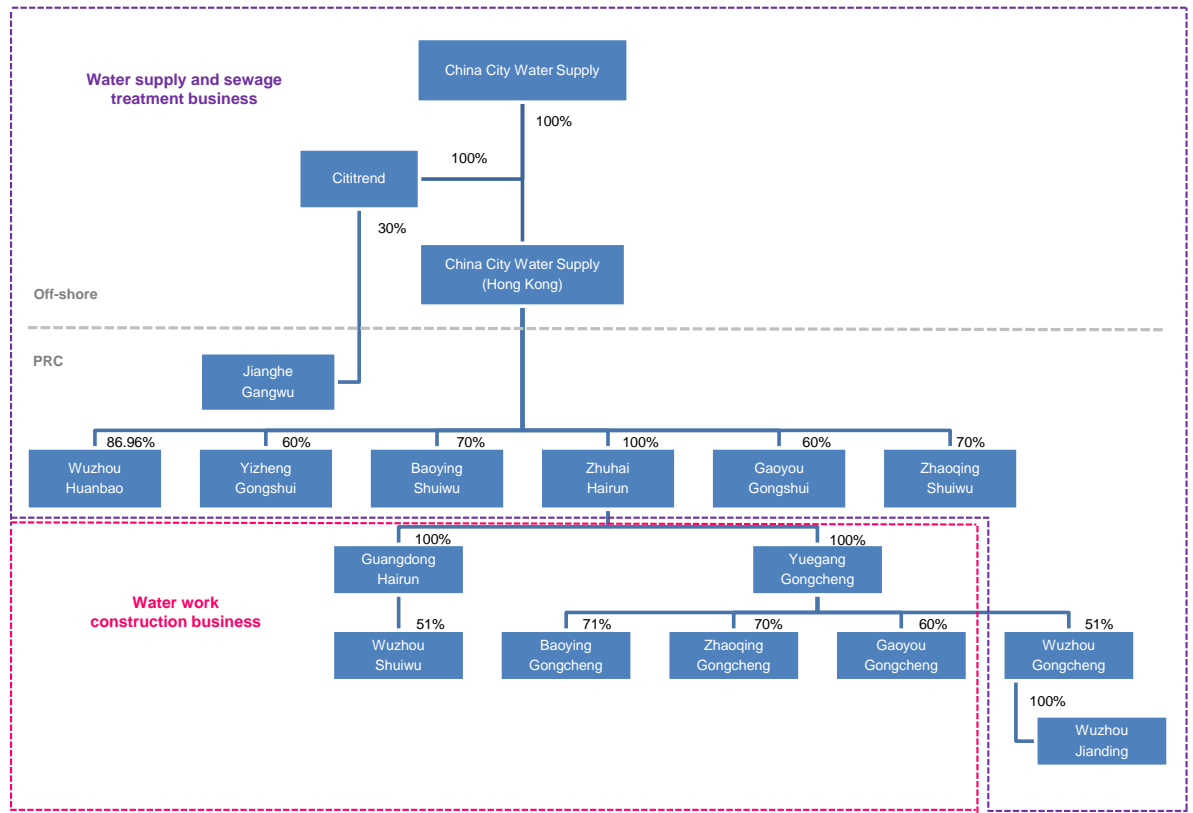
Figure 28: Water projects in operation

(tpd)	Location	Effective stake	Water supply	Sewage treatment	Investment (HK\$ m)	Date	Type of transaction	Seller
Wuhua	Guangdong	100%	N/A	40,000	188	Apr-17	PPP	Local gov
Jinsheng	Guangdong	90%	N/A	70,000	89	Feb-14	M&A	Third party
Daojiao	Guangdong	100%	N/A	40,000	49	Jun-14	M&A	Third party
Meizhou	Guangdong	70%	210,000	100,000	293	Sep-14	M&A	Third party
Kaiping	Guangdong	54%	N/A	50,000	27	Nov-14	M&A	Third party
Danzhou	Hainan	70%	100,000	N/A	221	Dec-15	M&A	Third party
Nansha	Guangdong	49%	400,000	N/A	150	Feb-12	M&A	Third party
Zhanjiang Suixi	Guangdong	70%	50,000	N/A	140	Jun-16	M&A	Third party
Baoying	Jiangsu	70%	130,000	N/A	2,964	Jun-15	M&A	GDH
Gaoyou	Jiangsu	60%	145,000	N/A				
Jianghe	Jiangsu	30%	520,000	N/A				
Yizheng	Jiangsu	60%	150,000	N/A				
Wuzhou	Guangxi	51%	355,000	90,000				
Zhaoqing	Guangdong	70%	90,000	N/A				
Qingxi Xingning	Guangdong	44%	290,000	3,000	650	Dec-15	M&A	Third party
Total			2,440,000	393,000	4,771			

Sources: Company data, GF Securities (Hong Kong)

The company's most noteworthy deal so far is the acquisition of a 100% stake in China City Water Supply in 2015, which operates six water supply plants, one sewage treatment plant, and five water work construction related projects in Guangxi, Guangdong and Jiangsu province. The company paid a total of Rmb993m (HK\$1,217m) for the acquisition, implying a 2.2% discount according to an independent auditor's valuation. We like this acquisition not only given its cheap valuation compared to a takeover premium in the industry, but also its strategic significance to the company. First, it has helped the company accelerate its coverage of the complete water resources management industry chain. Second, it has expanded the scale of the company's core business with potential synergy such as economies of scale, transfer of experience, technology and water quality improvement. Third, the acquisition has diversified the company's geographic exposure to fast-growing counties with rising populations and urbanization in Jiangsu province, while strengthening its leading position in Guangdong and Guangxi province.

Figure 29: Structure of acquiree China City Water Supply



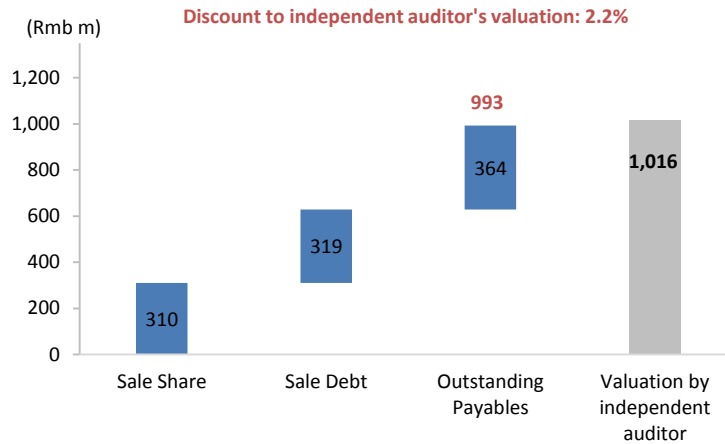
Sources: Company data, GF Securities (Hong Kong)

Figure 30: Key information about acquisition price

China City Water Supply Investment Holding	Type	Breakdown		
		Total (HK\$ m)	(Rmb m)	(HK\$ m)
Consideration	Sale share	380	310	0
	Sale debt	391	304	304
Repayment of outstanding payables	Outstanding paybles	446	244	164

Sources: Company data, GF Securities (Hong Kong)

Figure 31: Valuation benchmark



Sources: Company data, GF Securities (Hong Kong)

In addition, GDI has another eight water projects currently under construction with total water supply capacity of 280k tpd and sewage treatment capacity of 90k tpd. According to the company, approximately 210k tpd under-construction capacity will be completed this year. In addition, the company has won the bid for a new water resources project in Wuhua county of Meizhou, Guangdong province to build eleven sewage treatment plants with daily capacity of 1,000 tonnes. Total initial investment is approximately Rmb160m.

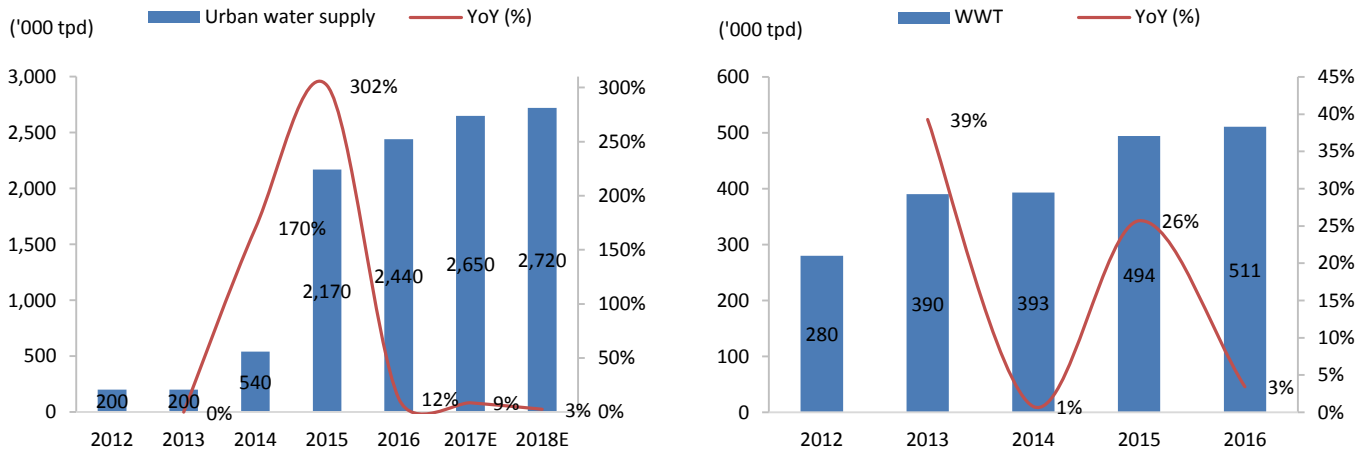
Figure 32: Projects under construction as of end-1Q17

Project	Sewage treatment	Water supply
	(tpd)	(tpd)
Hainan Danzhou	20,000	50,000
Zhanjiang Suixi	0	20,000
Wuhua	15,000	0
Shanwei	30,000	0
Gaozhou	0	100,000
Kaiping	25,000	0
Zhaoqing	0	50,000
Fengshun	0	60,000
Total	90,000	280,000

Sources: Company data, GF Securities (Hong Kong)

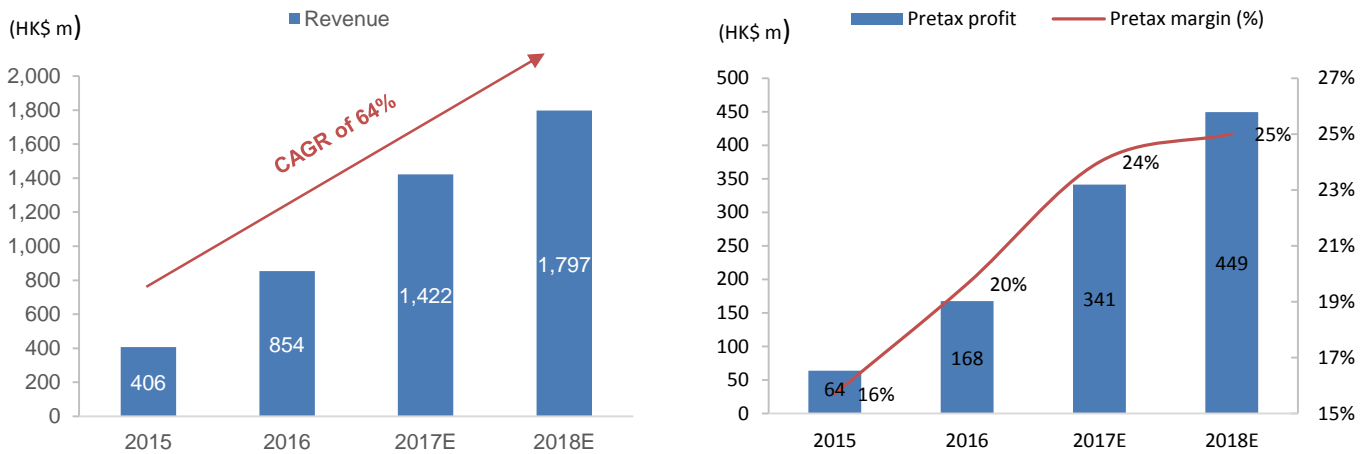
As such, we expect the company's water supply capacity to further increase 9% and 3% YoY to 2.65m/2.72m tpd by 2017/18 based on the current construction pipeline, representing a five-year CAGR of 69%. Furthermore, we expect the company's sewage treatment capacity to rise ~30% from the current level to 511,000 tpd by the end of 2018, boosting Water Group HK's revenue to ~HK\$1.8bn, more than doubling the figure in 2016. In addition, we expect Water Group HK's pretax profit to reach HK\$449m, implying a pretax margin of 25%, up 5pp from 20% in 2016. The increase in pretax margin will mainly be driven by the expanding sewage treatment business, which offers a much higher profit margin than the water supply business.

Figure 33: Rapid expansion of Water Group HK driven by M&A



Sources: Company data, GF Securities (Hong Kong)

Figure 34: Revenue and pretax profit forecasts for Water Group HK



Sources: Company data, GF Securities (Hong Kong)

Meanwhile, GDI has broadened the scope of its M&A to non-water business so as to cope with the deteriorating IRR of municipal sewage treatment projects in Guangdong and other provinces due to intensifying competition nationwide. For example, it re-entered the road business by acquiring the Xingliu Expressway project from its parent company in 2015 for an aggregate amount of HK\$2,588m, which has now become a key project contributing ~6% of company's total revenue and pretax profit. As part of the G80 Guangzhou-Kunming Expressway connecting Yunnan, Guangxi and Guangdong province, the Xingliu Expressway commenced operation in Aug 2003 with five toll stations located in Guangxi province. The main line is 99.6km long and the three branch lines have an aggregate length of 52.7km. According to the concession contract, the operation right of the Xingliu Expressway will expire in Sept 2032.

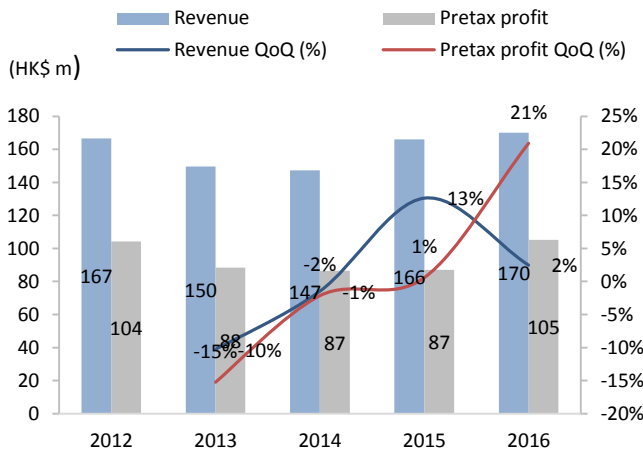
Figure 35: Location of Xingliu Expressway



Sources: Company data, GF Securities (Hong Kong)

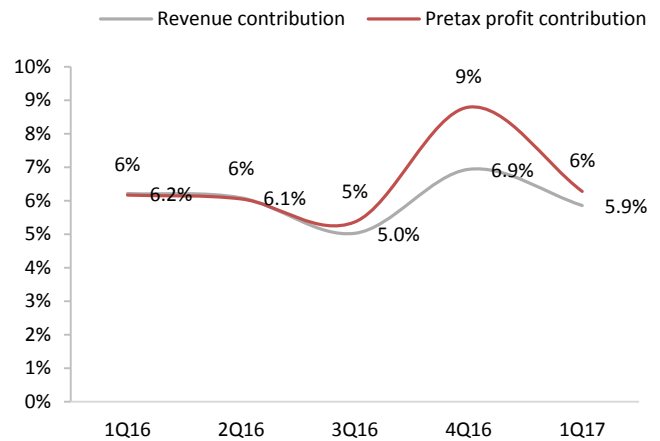
We like the Xingliu Expressway project given its: 1) strong fundamentals, 2) long-term stability, and 3) potential for further profit growth. The Xingliu Expressway is integral to one of the safest and most convenient routes from Guangdong/Guangxi to the coastal areas in southeastern China. It goes through the part of Guangxi that is most developed and active in trade which represents more than a third of the province's GDP. The Xingliu Expressway has a solid track record of generating stable income and maintaining high profitability with a 60%+ pretax margin since it came into operation in Aug 2003. Daily average traffic in 1Q17 was 26,919 vehicle-trips, up substantially by 20% from 2016. The company expects robust traffic growth for the Xingliu Expressway driven by continuously growing private vehicle ownership in Guangxi province. Therefore, we expect the Xingliu Expressway to become another profit and cash driver for the company in the near future.

Figure 36: Steady increase in both revenue and pretax profit generated by the Xingliu Expressway



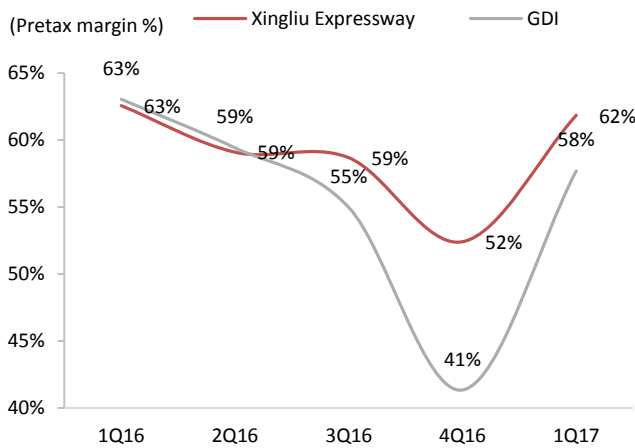
Sources: Company data, GF Securities (Hong Kong)

Figure 37: Xingliu Expressway contributed 6% of GDI's total revenue and pretax profit in 1Q17



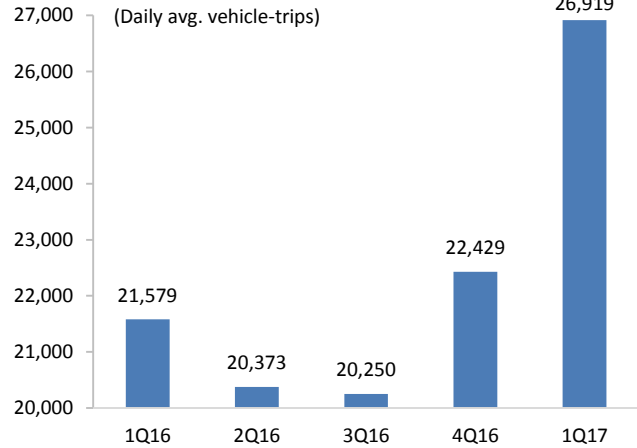
Sources: Company data, GF Securities (Hong Kong)

Figure 38: 60%+ pretax margin from Xingliu Expressway favorable for GDI's long-term profitability improvement



Sources: Company data, GF Securities (Hong Kong)

Figure 39: Xingliu Expressway to see further rise in daily average traffic thanks to favorable location

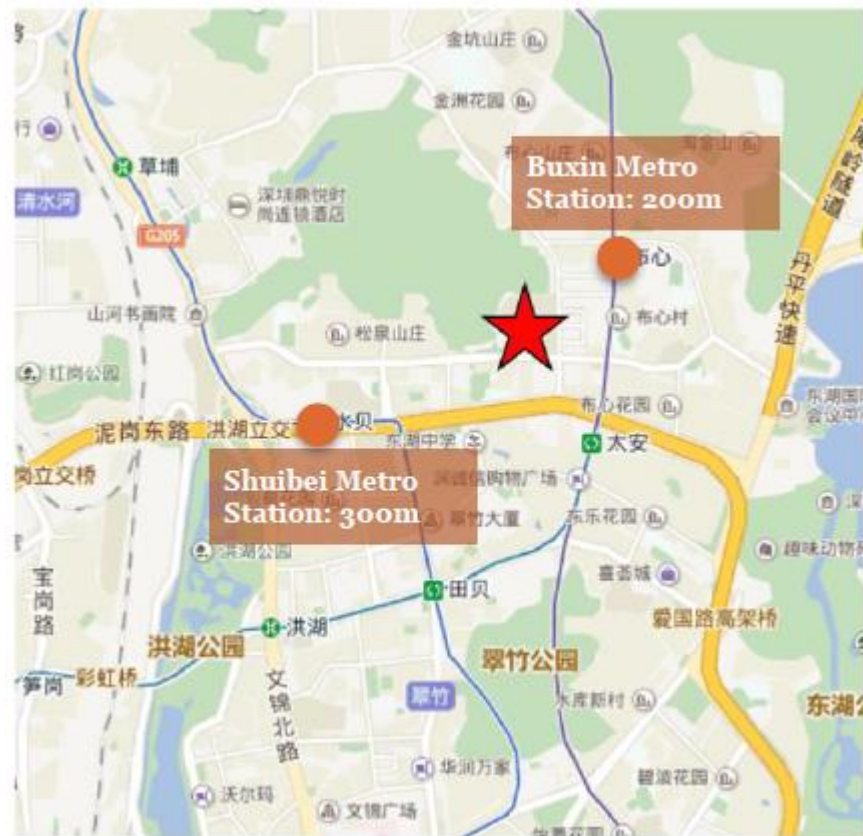


Sources: Company data, GF Securities (Hong Kong)

In addition, GDI expanded its property investment and development business by acquiring a 73.82% stake in Guangdong Land Holdings Limited (GDL; 124 HK, NR) from its parent company for a total consideration of Rmb3.358bn (equivalent to HK\$3.78bn) this April. GDL's main assets are the Buxin project and the Ruyingju project. According to the company, the Buxin Project, a property development project in Buxin, Luohu of Shenzhen, has a planned total site area of 66,526sqm with planned GFA of 432,051sqm. Meanwhile, a residential property development project in Panyu of Guangzhou, the Ruyingju Project has 917 residential units and 651 parking spaces; 90.2% of the project's total saleable area had been sold by the end of Sept 2016.

We particularly like the Buxin project for its superior location within the extended area of the Luohu CBD. The project sits next to the Buxin station on Shenzhen Metro Line 5 and the Shuibei station on Metro Line 3, providing easy access to the public transportation system within walking distance of 200m-300m. Moreover, the project is just 15 minutes away from the Luohu check point by car. The surrounding area is well equipped with educational and medical facilities, as well as public parks such as Weilingshan, Donghu, Honghu and Cuizhu parks. The project is designed as a multi-module commercial complex with a focus on the jewelry industry, matching the Luohu district government's design for the Shuibei-Buxin area. According to the company, Phase I of the project is expected to be completed in 2021 with pre-sale to commence in 2018, while Phase II is expected to be completed in 2023.

Figure 40: Location of the Buxin project

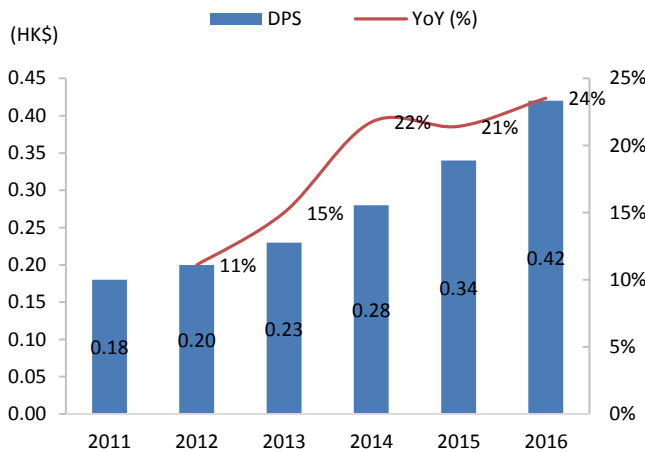


Sources: Company data, GF Securities (Hong Kong)

Cash cow & dividend yield play

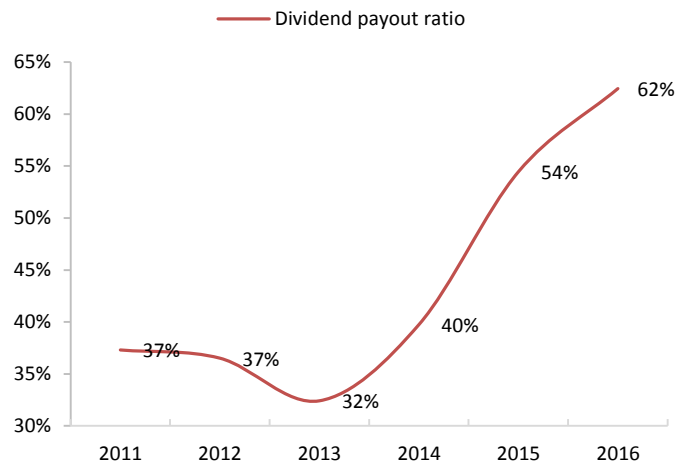
As our favorite dividend yield play, GDI continued to raise its dividend payout ratio over the past six years from 37% in 2011 to 62% in 2016. As a result, dividend per share increased at a CAGR of 16% to HK\$0.42 supported by the company's healthy cash flow, strong balance sheet and defensive business nature.

Figure 41: DPS grew at a CAGR of 16%



Sources: Company data, GF Securities (Hong Kong)

Figure 42: Continuously rising dividend payout ratio

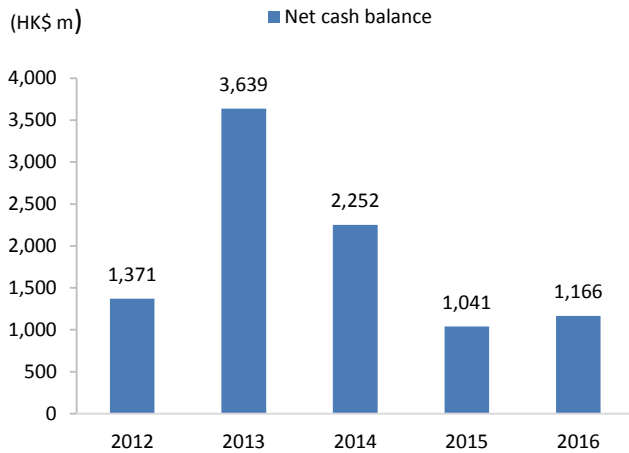


Sources: Company data, GF Securities (Hong Kong)

We like GDI's net cash position since 2012 despite its M&A expenses. Net cash reached HK\$1.17bn by the end of 2016, representing 12% YoY growth, in line with the steady growth in

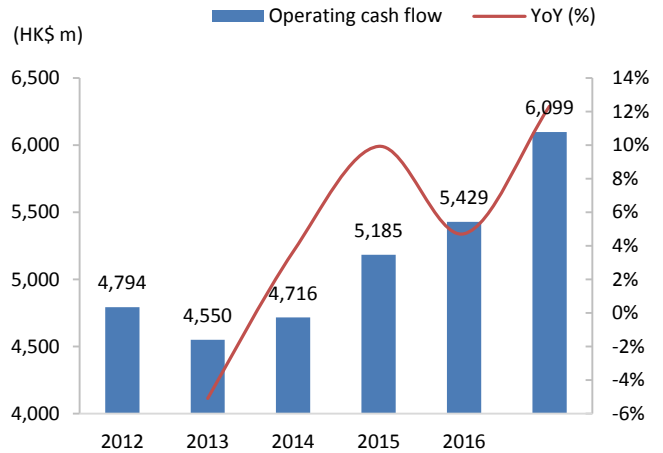
operating cash flow. In addition, the company has maintained a healthy debt servicing position with an EBITDA interest coverage of 54.47x at the end of 2016 vs. 45.42x at end-2015 thanks to its much lower-than-peers borrowing cost of ~2.5%.

Figure 43: Net cash position since 2012



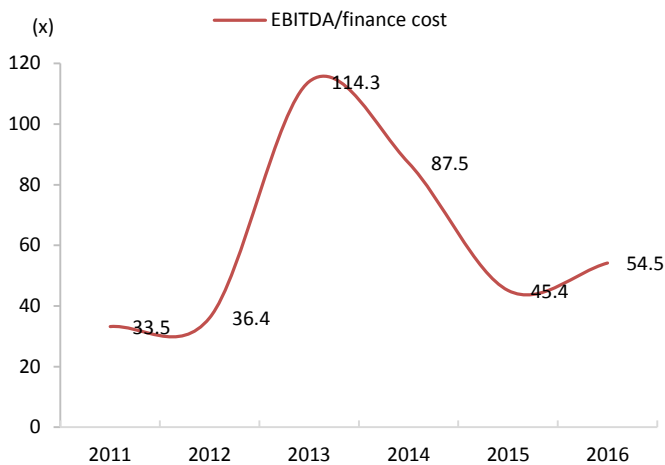
Sources: Company data, GF Securities (Hong Kong)

Figure 44: Steady increase in operating cash flow



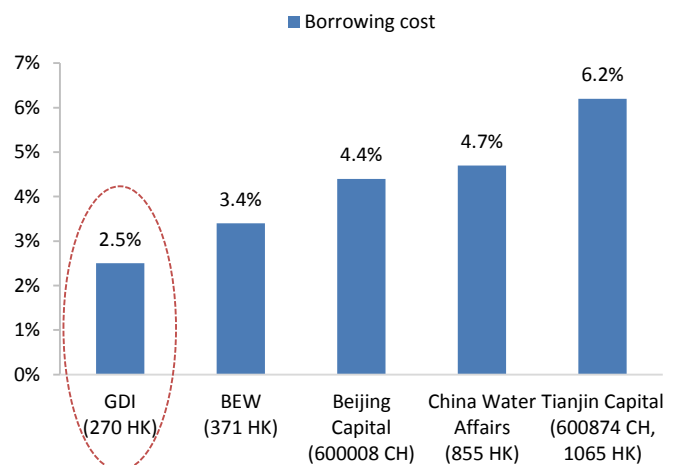
Sources: Company data, GF Securities (Hong Kong)

Figure 45: Healthy debt servicing position



Sources: Company data, GF Securities (Hong Kong)

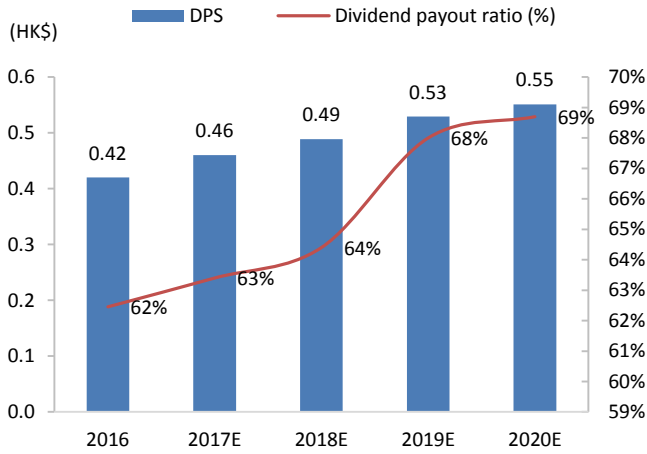
Figure 46: Lowest borrowing cost among peers



Sources: Company data, GF Securities (Hong Kong)

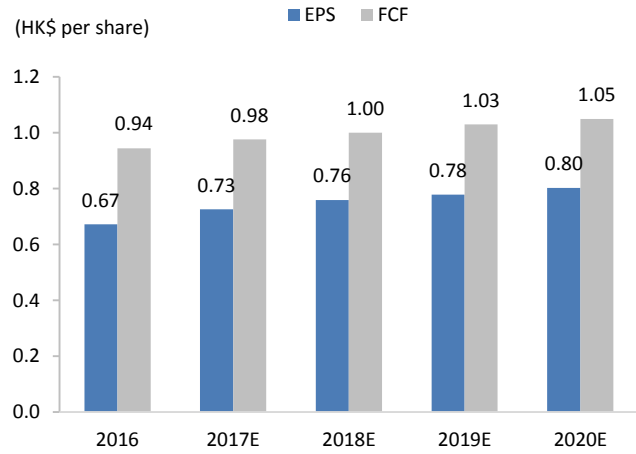
We expect GDI's DPS to grow at a CAGR of 6% during 2016-2020, suggesting a further improvement in its dividend payout ratio of 7pp (cumulative over the period), supported by steady growth in recurring FCF. We expect the company's FCF per share to remain greater than its EPS by growing 3% per annum during 2016-2020, as substantial non-cash items such as depreciation and amortization need to be subtracted when calculating EPS. The current stock price implies an 8.8%-9.4% FCF yield and a 4.1%-4.8% dividend yield, which are very attractive to us.

Figure 47: DPS to grow at 6% CAGR during 2016-2020 driven by continuously improving dividend payout ratio



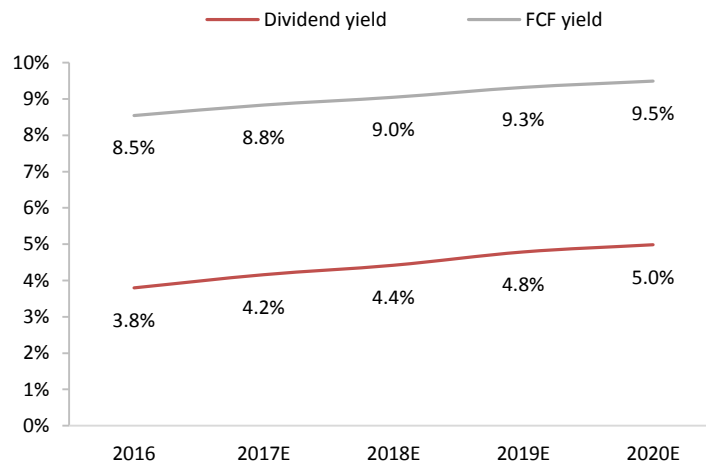
Sources: Company data, GF Securities (Hong Kong)

Figure 48: FCF per share to remain above EPS by growing 3% per annum on average



Sources: Company data, GF Securities (Hong Kong)

Figure 49: Attractive FCF yield and dividend yield

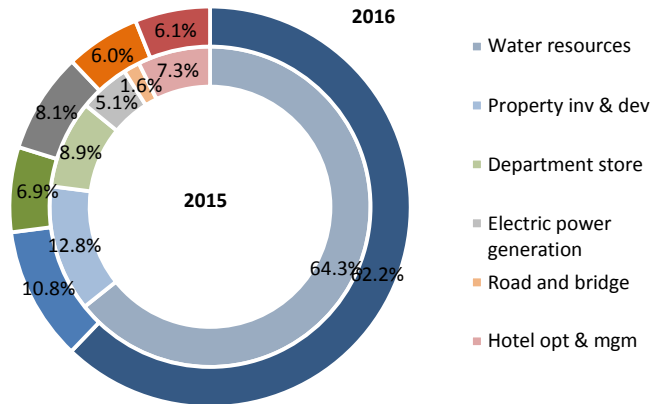


Sources: Company data, GF Securities (Hong Kong)

GDI is a cash cow with its 1) property investment and development, 2) department store, 3) hotel operation and management, 4) electric power generation, and 5) road and bridge businesses. The five segments combined contributed 37.8% and 36.9% of company's 2016 revenue and profit, in the amounts of HK\$3.9bn and HK\$1.76bn respectively.

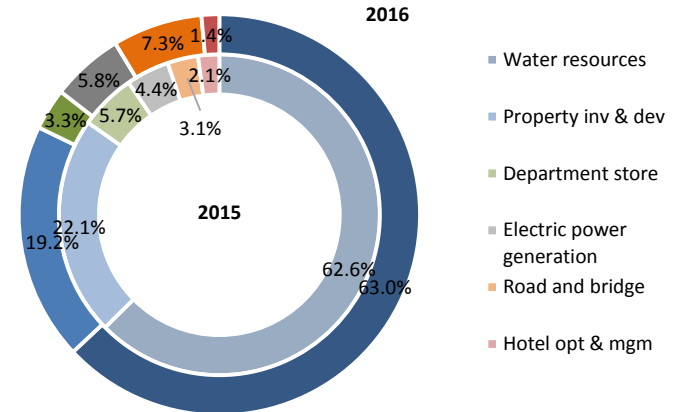
Foreseeable upside to property investment & development in mid/long-term GDI currently has four property projects in both mainland China and Hong Kong, namely Teem Plaza in Guangdong province, Teem Shopping Mall in Tianjin, Guangdong Investment Tower in Hong Kong, and the Panyu Wanbo CBD project in Guangzhou city. Revenue from the property investment & management segment has remained above HK\$1.1bn in recent years with a pretax margin of more than 70% thanks to occupancy rates of approximately 100% at older projects and greatly improved occupancy rates at relatively newer ones.

Figure 50: Revenue breakdown by segment



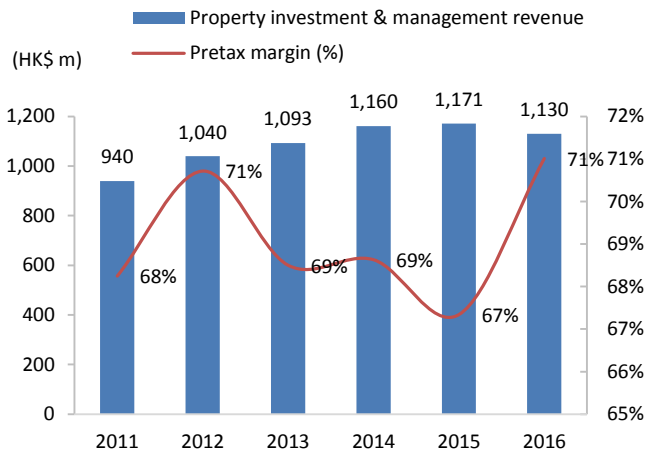
Sources: Company data, GF Securities (Hong Kong)

Figure 51: Net profit breakdown by segment



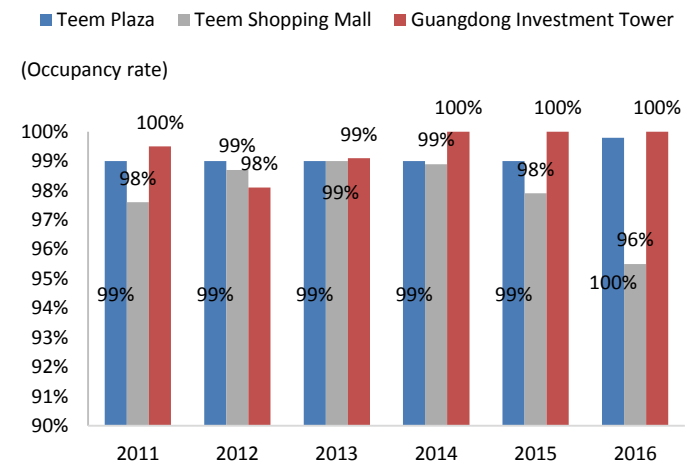
Sources: Company data, GF Securities (Hong Kong)

Figure 52: Steady property business revenue...



Sources: Company data, GF Securities (Hong Kong)

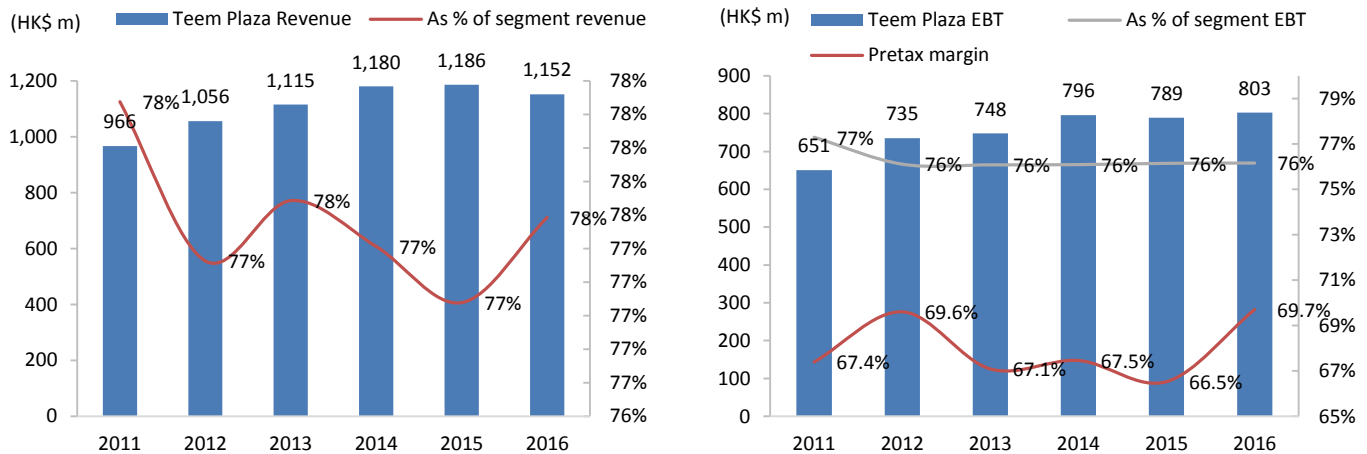
Figure 53: ...thanks to ~100% occupancy rates



Sources: Company data, GF Securities (Hong Kong)

Teem Plaza, in which the company has an effective interest of 76.13%, is the largest revenue and profit contributor, accounting for 78%/76% of segment revenue/profit in 2016. While the revenue from Teem Plaza, which consists of rental income from the shopping mall, office building and department stores, declined 2.8% YoY to HK\$1.15bn in 2016 due to the negative impact of exchange rate changes, adjusted revenue after excluding the impact of currency translation actually rose 3.4% YoY. The pretax margin of the project also improved by more than 3pp to 69.7% last year after adjusting for changes in fair value of investment properties and net interest income. As such, we expect Teem Plaza to continue to bring considerable rental income to the company on the back of a ~100% occupancy rate and a small increase in the average lease rate. The project is located in the prime area of Guangzhou with lettable area of 103,000 sqm out of 160,000 sqm of floor area.

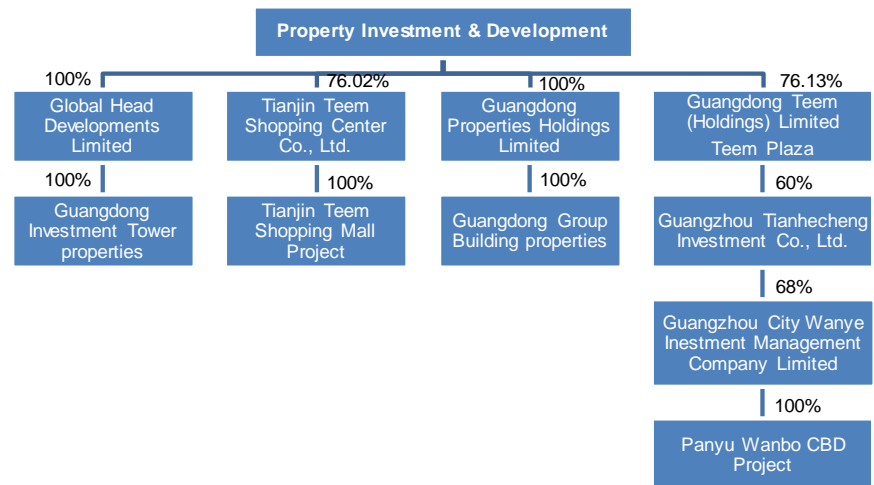
Figure 54: Teem Plaza largest segment revenue and pretax profit contributor



Sources: Company data, GF Securities (Hong Kong)

Teem Shopping Mall and the Panyu Wanbo CBD project are currently under development, which are expected to enhance segment profit substantially in the mid/long term. The Tianjin project is to develop a large-scale modern shopping mall with a total gross floor area of ~137,100 sqm/56,000 sqm above ground/underground. The company has invested ~HK\$2.3bn in the project so far. The other project is to develop a large-scale integrated commercial project in the Panyu Wanbo CBD, which covers a gross floor area of ~260,000 sqm. Around HK\$2.1bn had been invested as at the end of 1Q17 based on a cooperation agreement for the project.

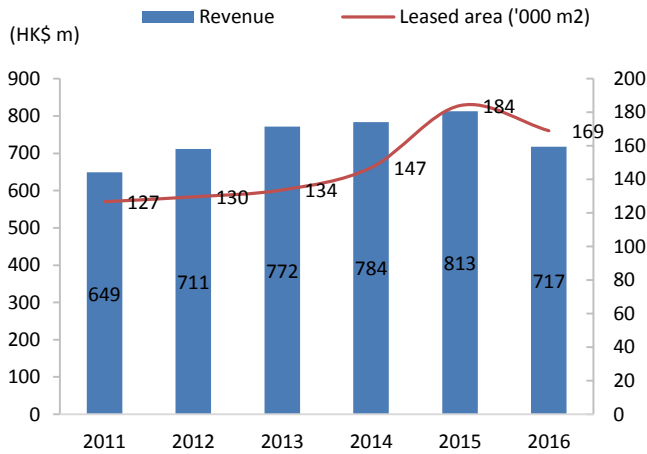
Figure 55: Business structure of company's property investment & development segment



Sources: Company data, GF Securities (Hong Kong)

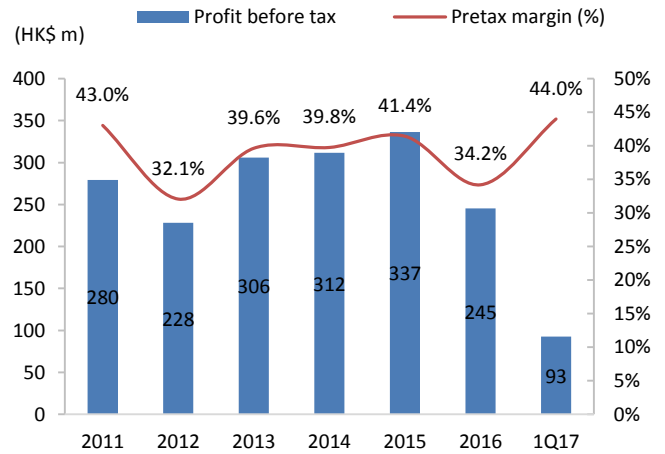
Potential synergy with property investment & development to provide buffer for department store operation. As of the end of 1Q17, GDI was operating eight department stores with a total leased area of ~169,000sqm, among which Teemall Store accounted for 69.3% of segment revenue. Although operating income from Teemall Store declined 13.1% YoY in full-year 2016 due to an increasingly competitive industry environment, which dragged segment revenue down by 11.7% YoY, it rebounded 11.7% YoY in 1Q17. Therefore, department store operation recorded total revenue of HK\$209.5m in 1Q17, up 2.2% YoY, partially offset by the closure of Baiyun New Town Store last July. Thanks to its synergy with the property investment & development business, the segment's pretax profit rose 10.9% YoY to HK\$92.6m in 1Q17, representing a pretax margin of 44%, improving significantly by 10pp compared to 2016. Teemall Store sits within the Teem Plaza, thus benefiting from a lower rental, better location with higher visitor flows, and lower operating cost by sharing the majority of staff with the shopping mall.

Figure 56: Department store operation segment revenue



Sources: Company data, GF Securities (Hong Kong)

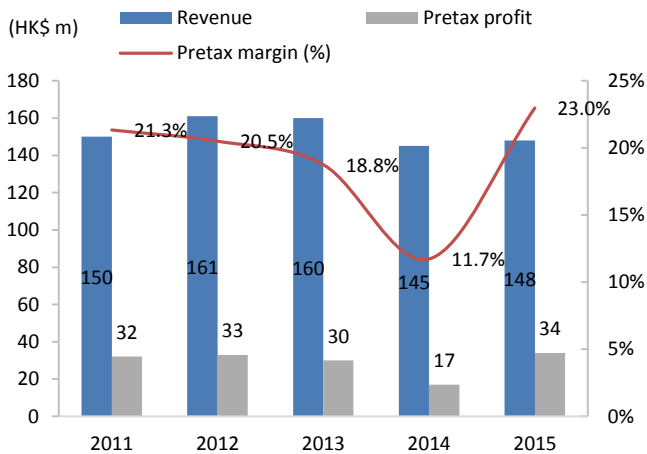
Figure 57: Pretax margin improved significantly in 1Q17



Sources: Company data, GF Securities (Hong Kong)

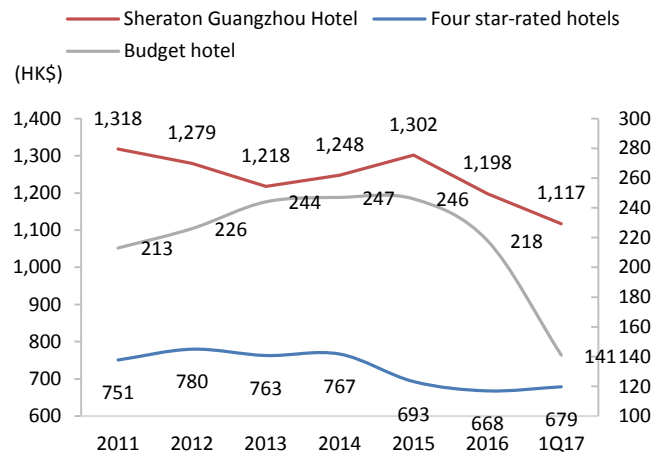
Steady income from hotel operation and management As of the end of 1Q17, GDI was managing 32 hotels in mainland China, Hong Kong and Macau, among which six are owned or lease-owned by the company. Five of the six are star rated hotels with the other a budget hotel. Total revenue from the segment amounted to HK\$148m in 1Q17, up slightly by 2.1% YoY, mainly due to an improved occupancy rate at the four star-rated hotels managed by the company to 77.6% (1Q16: 71.3%). Nonetheless, quarterly segment pretax profit rebounded significantly from HK\$17m to HK\$34m as the pretax margin doubled to ~23%. A better occupancy rate of 88.1% (1Q16: 87.3%) was also seen at the five-star Sheraton Guangzhou Hotel, which is managed by Sheraton Overseas Management Corporation rather than company's own hotel management team. However, the average room rate at Sheraton Guangzhou Hotel dropped 5.6% YoY to HK\$1,117, in line with the YoY decline at the company's other four star-rated hotels. While the average room rate is likely to continue to decline going forward, we expect the downward pressure on earnings to be partially offset by the rising occupancy rate at Sheraton Guangzhou Hotel and overall operating efficiency.

Figure 58: Quarterly revenue and pretax profit of hotel operation and management



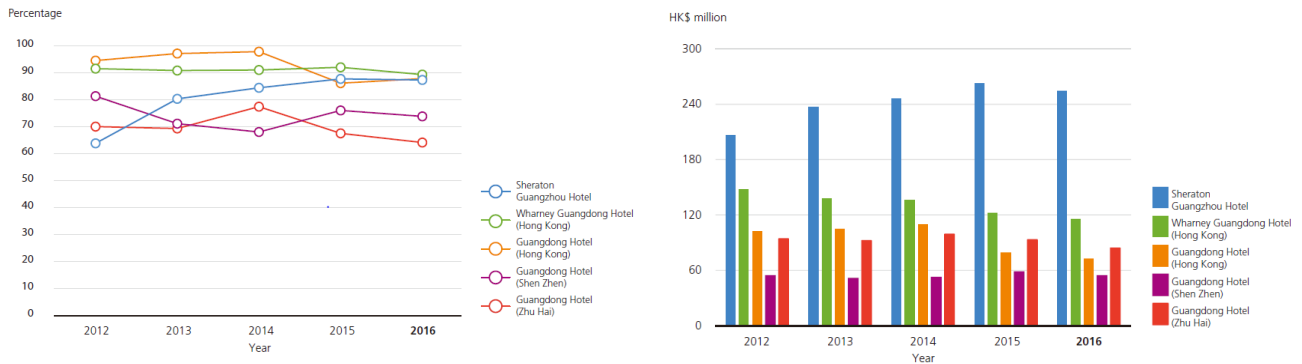
Sources: Company data, GF Securities (Hong Kong)

Figure 59: Average room rate likely to continue to decline



Sources: Company data, GF Securities (Hong Kong)

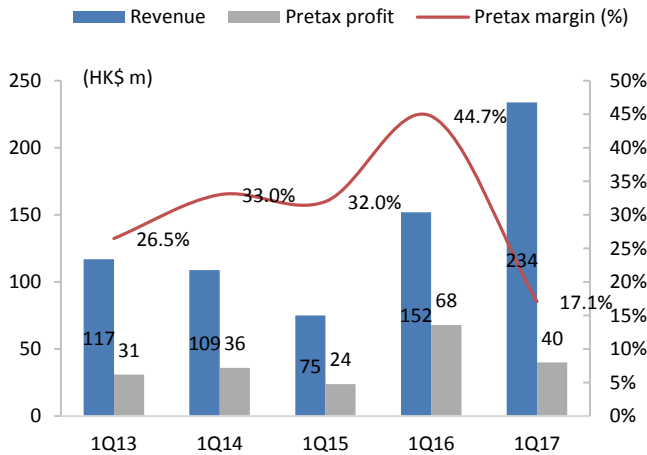
Figure 60: Occupancy rates and revenue at specific hotels



Sources: Company data, GF Securities (Hong Kong)

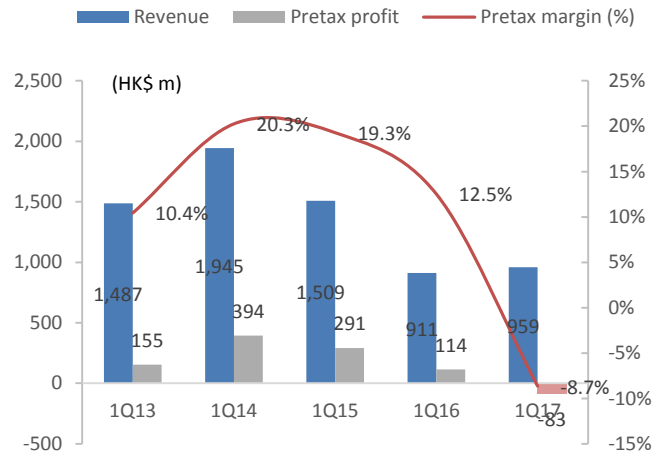
Power business profit to bottom out in 2H17 GDI currently has a 100% stake in Zhongshan Thermal Power Plant and 25% stakes in each of Yudean Jinghai Power and Meixian Power. As the two power plants that contribute to the company's consolidated income statement, Zhongshan Thermal Power Plant and Yudean Jinghai Power together have six generating units with a total installed capacity of 3,800MW. In 1Q17, the two power plants' revenue grew 53.6%/52.5% YoY to HK\$234m/959m, driven by 65.8%/17.2% YoY increase in electricity sales. However, pretax profit was hurt badly due to the jump in coal prices: Zhongshan Thermal Power Plant suffered a 41.4% YoY decline in pretax profit while Yudean Jinghai Power saw a pretax loss of HK\$82.7m, which resulted in a pro rata loss of HK\$20.2m on GDI's consolidated income statement. As the coal price has stabilized and coal-fired power companies will receive an on-grid tariff hike starting from 2H17, we expect the earnings of the company's power business to bottom out given strong power demand and better-than-national-average utilization hours in Guangdong province where the two power plants are located.

Figure 61: Quarterly operating metrics of Zhongshan Power Plant



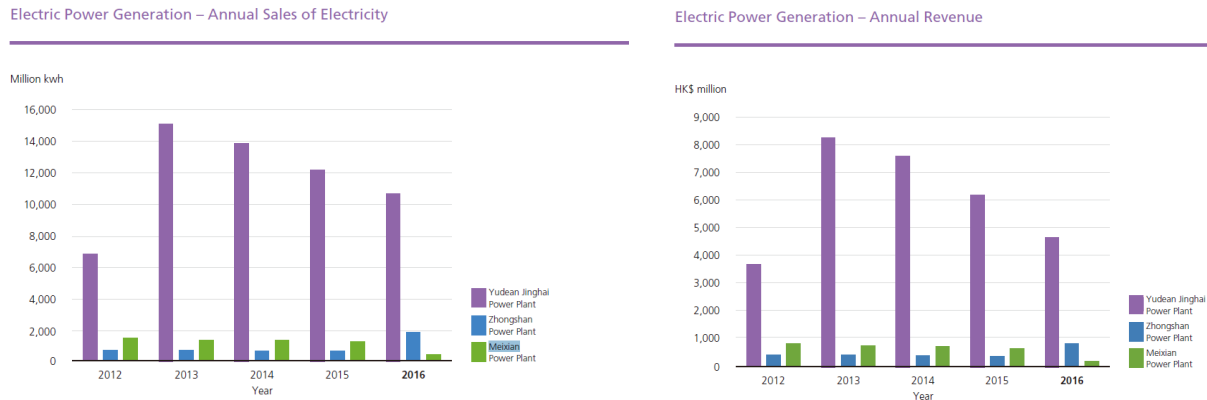
Sources: Company data, GF Securities (Hong Kong)

Figure 62: Quarterly operating metrics of Yudean Jinghai Power



Sources: Company data, GF Securities (Hong Kong)

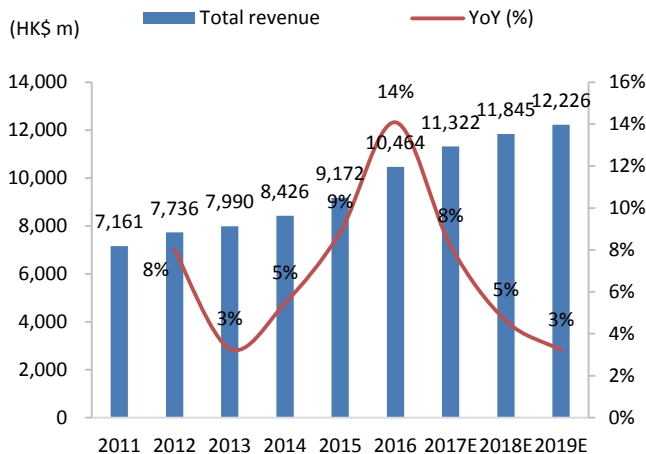
Figure 63: Annual operating metrics of company's power business



Sources: Company data, GF Securities (Hong Kong)

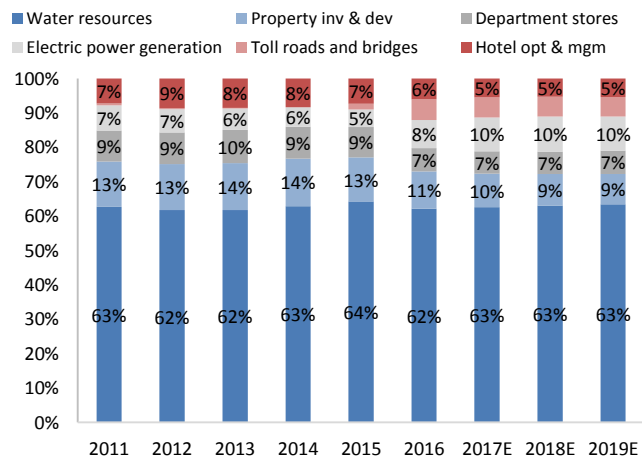
We expect company revenue to grow 8%/5%/3% YoY to HK\$11.3bn/11.8bn/12.2bn in 2017/18/19, driven by 10.3%/58.9%/5.4% YoY growth in its water resources segment, which accounts for 63% of total revenue. The growth slowdown in the water resources segment is mainly due to a smaller tariff hike under the new term of the Dongshen water supply project, which alone contributes approximately 87% of water resources revenue. We estimate that revenue from property investment and development will stabilize at ~HK\$1.1bn in 2017/18/19 given the relatively stable performance of Teem Plaza. In the mid/long term, we see significant upside brought by the company's newly secured large-scale shopping mall project in Tianjin and the integrated commercial project in the Panyu Wanbo CBD. We believe the company's department store business will also benefit from potential synergy with its shopping malls, with segment revenue to rise 2.9%/5%/6% YoY to HK\$738m/775m/882m in 2017/18/19, accounting for 7% of total revenue. The electric power generation business is likely to record revenue of HK\$1.1bn/1.2bn/1.2bn in 2017/18/19 as an on-grid tariff hike will be effective in 2H17 despite continued pressure on utilization hours and the expanding scale of market-driven power sales. We are optimistic that the declining trend in the company's hotel operation and management segment will cease in 2018 with a rebound to take off in 2019; as such, we estimate 2017/18/19 revenue of HK\$619m/625m/655m, representing -2.3%/0.9%/4.7% YoY growth. We expect the company's road and bridge business to generate HK\$661m/681m/695m of revenue in 2017/18/19 to account for 5% of total revenue. GDI re-entered the toll road and bridge business in 2015 by acquiring the Xingliu Expressway project from its parent company. **We estimate a gross margin of 67.4% in 2017/18/19 backed by the defensive nature of most of the company's businesses.** Excluding the changes in fair value of investment properties, EBIT is likely to increase 9%/5%/3% YoY to HK\$6.4bn/6.7bn/7.0bn in 2017/18/19, representing an EBIT margin of 57%. As a result, the company's recurring profit is likely to reach HK\$4.7bn/5.0bn/5.1bn in 2017/18/19, equivalent to an EPS of HK\$0.73/0.76/0.78.

Figure 64: Total revenue forecasts



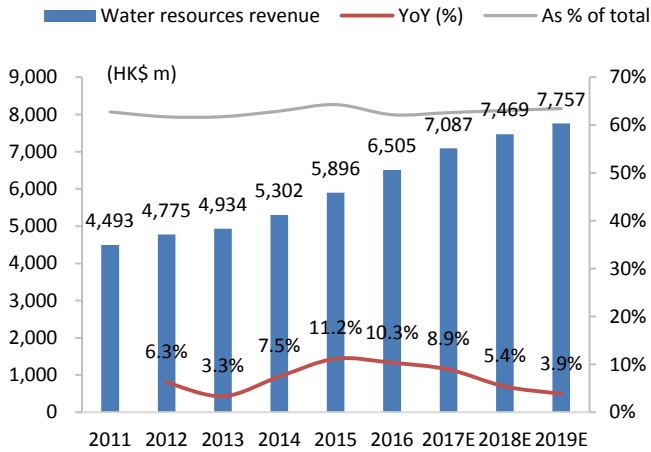
Sources: Company data, GF Securities (Hong Kong)

Figure 65: Total revenue breakdown



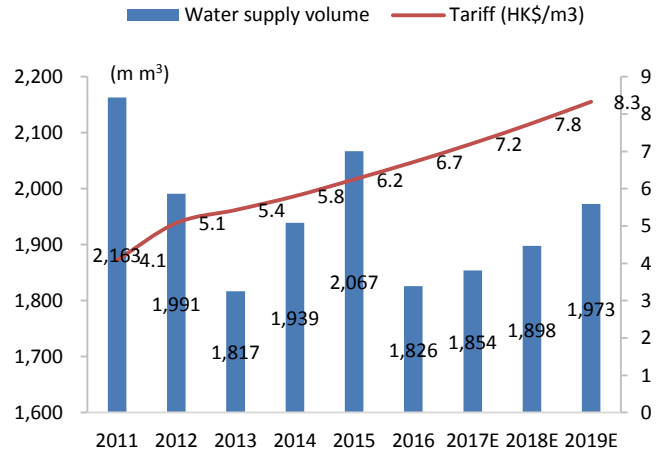
Sources: Company data, GF Securities (Hong Kong)

Figure 66: Water resources revenue forecasts



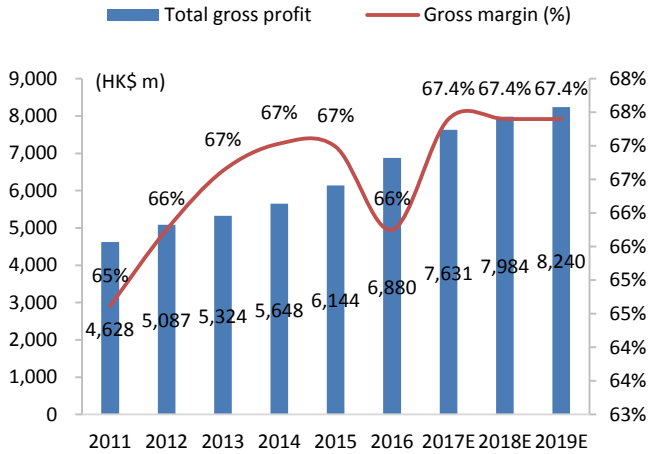
Sources: Company data, GF Securities (Hong Kong)

Figure 67: Dongshen water supply forecasts



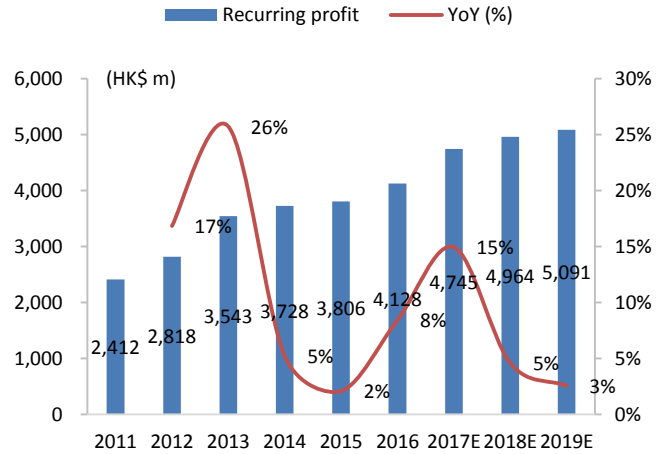
Sources: Company data, GF Securities (Hong Kong)

Figure 68: Gross profit and margin forecasts



Sources: Company data, GF Securities (Hong Kong)

Figure 69: Recurring profit forecasts



Sources: Company data, GF Securities (Hong Kong)

Figure 70: GF estimates vs. consensus

(HK\$ m)	GF estimates			Consensus			Difference (%)		
	2017E	2018E	2019E	2017E	2018E	2019E	2017E	2018E	2019E
Revenue	11,322	11,845	12,226	11,378	12,023	12,783	-1%	-1%	-1%
COGS	3,691	3,862	3,986	3,408	3,638	3,551	8%	6%	8%
Gross profit	7,631	7,984	8,240	7,970	8,384	9,231	-4%	-5%	-4%
EBIT	6,437	6,735	6,952	6,080	6,349	6,676	6%	6%	6%
Pretax Income	6,486	6,785	7,006	6,527	6,741	7,105	-1%	1%	-1%
Net profit	4,745	4,964	5,091	4,798	4,939	5,122	-1%	0%	-1%
EPS(HK\$)	0.73	0.76	0.78	0.75	0.78	0.82	-4%	-3%	-4%

Sources: Bloomberg, Company data, GF Securities (Hong Kong)

Valuation and recommendation

We initiate coverage of the company with an Accumulate rating and target price of HK\$12.0, implying 16x/15x 2018/19E P/E. The stock is currently trading at 14.6x/14.3x 2018/19E P/E, higher than the industry average. **We believe GDI deserves a premium given its defensive business nature**, which is firmly backed by: **1)** a highest dividend yield of 4.1%-4.8% among peers; **2)** its strong balance sheet with a net cash position of HK\$1.17bn; **3)** a healthy debt servicing position with an EBITDA interest coverage of 54.47x at end-2016; **4)** robust cash flow with an 8.8%-9.4% FCF yield; and **5)** low vulnerability to exchange rate fluctuations.

Figure 71: Valuations of comparable companies

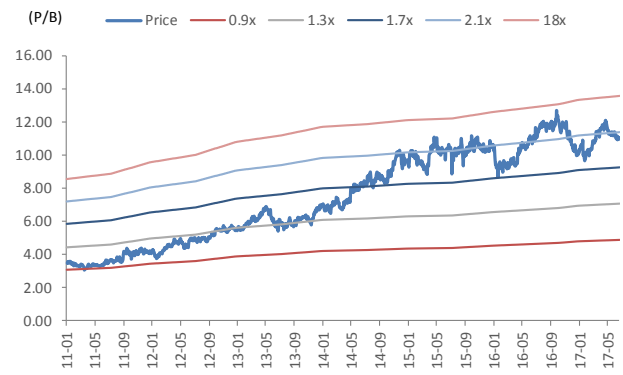
Company	Ticker	Price (HK\$)	Market cap (HK\$ bn)	P/E			P/B			ROE			Net margin		
				2017E	2018E	2019E	2017E	2018E	2019E	2017E	2018E	2019E	2017E	2018E	2019E
Guangdong Investment	270 HK	11.1	72.7	15.3	14.6	14.3	2.1	2.0	1.9	13.7%	13.6%	13.2%	41.9%	41.9%	41.6%
China Everbright International	257HK	10.1	45.2	13.3	11.2	9.9	2.3	2.0	1.8	17.4%	18.3%	18.1%	20.9%	22.3%	22.6%
Canvest	1381 HK	4.22	10.4	18.7	15.0	12.5	7.8	5.7	4.2	41.8%	37.7%	33.4%	23.6%	27.0%	27.0%
Beijing Enterprise Water Group	371 HK	6.5	56.9	12.0	11.5	11.2	2.6	2.3	2.0	21.4%	19.7%	17.7%	19.8%	17.4%	16.8%
Dynagreen	1330 HK	4.01	4.2	3.1	2.6	2.3	0.5	0.4	0.4	14.6%	15.2%	15.6%	17.4%	18.1%	19.4%
Yunnan Water Group	6839 HK	3.59	4.3	2.2	1.9	1.8				N/A			11.8%	12.4%	12.9%
CTE	1363 HK	1.42	9.0	11.4	9.3	7.9	2.1	1.8	1.5	18.2%	18.9%	18.9%	33.4%	34.4%	35.3%
China Everbright Greentech	1257HK	5.59	11.5	13.3	10.5	9.2	11.0	10.0	9.0	83.1%	95.2%	97.6%	18.8%	18.2%	16.2%
Dongjiang Environment	895 HK	12.9	16.2	19.0	15.3	12.9	2.7	2.3	2.0	14.0%	15.3%	15.7%	15.9%	16.1%	16.5%
Industry Average		6.04	19.7	11.6	9.7	8.5	4.1	3.5	3.0	30.1%	31.5%	31.0%	20.2%	20.7%	20.8%

Sources: Bloomberg consensus, company data, GF Securities (Hong Kong)
 Note: Calculated based on closing prices on 20 Jul 2017.

Figure 72: Historical P/E band



Figure 73: Historical P/B band



Sources: Bloomberg, Company data, GF Securities (Hong Kong)

Figure74: Financial statements

Income statement						Cash flow statement					
(HK\$ m)	FY15	FY16	FY17E	FY18E	FY19E	(HK\$ m)	FY15	FY16	FY17E	FY18E	FY19E
Revenue	9,172	10,464	11,322	11,845	12,226	Net income	3,905	4,212	4,745	4,964	5,091
Cost of sales	-3,028	-3,584	-3,691	-3,862	-3,986	D&A	1,116	1,348	1,361	1,375	1,388
Gross profit	6,144	6,880	7,631	7,984	8,240	Change in working capital	-252	-345	-215	-120	-167
Other income	813	552	597	625	645	Other operating cash flow	660	884	476	498	515
Administrative expenses	-1,345	-1,398	-1,528	-1,599	-1,651	Operating cashflow	5,429	6,099	6,368	6,717	6,826
Other operating expenses	-217	-242	-283	-296	-306	Capex	-1,457	-560	-371	-375	-378
Operating profit	5,549	5,923	6,437	6,735	6,952	Change in investment	-29	2,205	-42	23	64
Finance costs	-136	-130	-91	-92	-93	Other investing cashflow	-3,116	-504	20	20	21
Other non-recurring items	-166	-42	140	142	147	Investing cashflow	-4,543	-3,267	-308	-377	-422
Pretax income	5,246	5,752	6,486	6,785	7,006	Change in bank borrowings	2,809	-2,020	-1,834	36	36
Income tax	-957	-1,100	-1,265	-1,323	-1,401	Dividend paid	-1,877	-2,255	-2,633	-3,008	-3,197
Net profit	4,289	4,652	5,221	5,462	5,605	Other financing cashflow	22	157	-350	-381	-278
Minority interests	384	440	476	498	515	Financing cashflow	955	-4,118	-4,816	-3,354	-3,438
Net profit attributable to shareholders	3,905	4,212	4,745	4,964	5,091	Net changes in cashflow	1,399	-1,684	1,243	2,986	2,967
Balance sheet						Key assumptions & indicators					
Current assets						Revenue breakdown					
Cash and cash equivalents	9,295	7,194	8,437	11,423	14,389	Water resources	5,896	6,505	7,087	7,469	7,757
Receivables	746	813	879	918	947	Property investment and development	1,160	1,171	1,130	1,106	1,089
Inventories	143	126	130	136	140	Department stores	784	813	717	738	775
Other current assets	6,307	7,751	8,407	8,818	9,113	Electric power generation	479	471	847	1,109	1,206
Total current assets	16,492	15,885	17,852	21,295	24,590	Toll roads and bridges	0	150	630	661	681
Non-current assets						Hotel operations and management	701	672	634	619	625
PP&E	7,083	6,692	6,386	6,077	5,766	% of Total Revenue					
Goodwill	304	301	301	301	301	Water resources	64%	62%	63%	63%	63%
Receivables	438	417	397	377	356	Property investment and development	13%	11%	10%	9%	9%
Deferred tax assets	47	62	62	62	62	Department stores	9%	8%	6%	6%	6%
Other non-current assets	29,747	28,774	28,047	27,379	26,745	Electric power generation	5%	4%	7%	9%	10%
Total non-current assets	37,618	36,246	35,193	34,196	33,229	Toll roads and bridges	0%	1%	6%	6%	6%
Total assets	54,110	52,130	53,045	55,491	57,819	Hotel operations and management	8%	6%	6%	5%	5%
Current liabilities						YoY (%)					
Bank and other borrowings	556	1,012	670	677	684	Revenue	9%	14%	8%	5%	3%
Corporate bonds	0	1	2	3	4	Gross profit	9%	12%	11%	5%	3%
Payables	4,854	4,361	4,240	4,186	4,063	Operating profit	-5%	7%	9%	5%	3%
Other current liabilities	368	199	204	212	218	Pretax income	-14%	10%	13%	5%	3%
Total current liabilities	5,778	5,573	5,116	5,078	4,968	Net profit attributable to shareholders	-11%	8%	13%	5%	3%
Non-current liabilities						Profit margin (%)					
Bank and other borrowings	7,016	16,663	25,515	32,855	38,998	Gross margin	67.0%	65.8%	67.4%	67.4%	67.4%
Deferred tax liabilities	2,736	2,514	2,514	2,514	2,514	Operating margin	60.5%	56.6%	56.9%	56.9%	56.9%
Notes payable	0	0	0	0	0	Net margin	42.6%	40.3%	41.9%	41.9%	41.6%
Other payables	0	0	0	0	0	ROE	12.4%	13.1%	13.7%	13.6%	13.2%
Other non-current liabilities	1,312	-10,857	-21,201	-28,513	-34,626	ROA	7.7%	7.9%	9.0%	9.1%	9.0%
Total non-current liabilities	11,064	8,319	6,827	6,856	6,886	Ratio per share					
Total liabilities	16,843	13,892	11,943	11,935	11,854	EPS (HK\$/share)	0.62	0.67	0.73	0.76	0.78
Reserves	25,760	26,432	28,545	30,500	32,394	BVPS (HK\$/share)	4.81	4.93	5.29	5.59	5.88
Issued capital	5,712	5,790	6,064	6,064	6,064	DPS (HK\$/share)	0.34	0.42	0.46	0.49	0.53
Equity attributable to shareholders	31,472	32,222	34,609	36,564	38,458	Interest coverage	45.4	54.5	85.6	88.3	90.1
Non-controlling interests	5,795	6,017	6,493	6,992	7,506	Dividend payout ratio	54%	62%	63%	64%	68%
Total shareholder's equity	37,267	38,239	41,102	43,556	45,965	Current ratio	2.85	2.85	3.49	4.19	4.95

Sources: Company data, GF Securities (Hong Kong)

Rating definitions

Benchmark: Hong Kong Hang Seng Index

Time horizon: 12 months

Company ratings

Buy	Stock expected to outperform benchmark by more than 15%
Accumulate	Stock expected to outperform benchmark by more than 5% but not more than 15%
Hold	Expected stock relative performance ranges between -5% and 5%
Underperform	Stock expected to underperform benchmark by more than 5%

Sector ratings

Positive	Sector expected to outperform benchmark by more than 10%
Neutral	Expected sector relative performance ranges between -10% and 10%
Cautious	Sector expected to underperform benchmark by more than 10%

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