



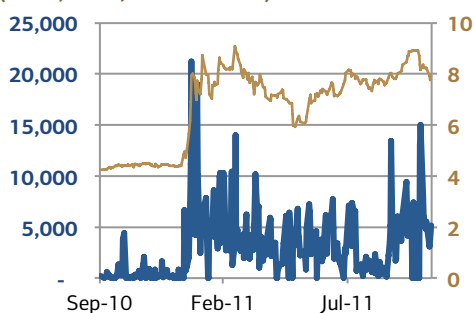
September 30, 2014

China | Environmental Industries Sound Global Ltd. (967 HK)

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Sound Global Ltd. (967 HK) one-year share price in HKD (gold) and volume (blue, in 1,000 shares)



Source: Bloomberg, September 30, 2014

Sound Global Ltd. (967 HK)

Price	HKD 7.77
Rating	SELL
Price target	HKD 3.48
Difference	55%
Market Cap	HKD 11.8 bln
Simple Moving Avg.	4.68 mln
P/E	17.2x

Source: Google Finance, September 30, 2014

Unsound deal

+ Founder's payday?

Sound Global recently announced the purchase of assets from its A-listed sister company in a deal whose clearest benefit is probably the founder's. Chairman Wen Yibo will make HKD 2.1 bln by selling about 265 mln shares held by his vehicle Sound Water. Direct ownership of Wen Yibo and his entities will decrease to 28.0% from 51.3%, and total shareholdings, including those held in Sound Environment, will be at 41.1%. Sound Environment's announcement indicates that Sound Global's shareholding in SE will also be diluted, to 42.3% from 44.6%, as the company will subscribe to only 30% of the new shares in SE.

+ Sister love

Besides offering a payout to Wen Yibo, the deal looks like a favor to Sound Environment, the sister company, and a sacrifice by Sound Global, which acquired a money-losing asset that may not be able to collect its debts. The deal should push down Sound Global's margins. The real winner is Sound Environment, which now can focus on the higher-growth solid waste business and also share in the profit of Sound Global after the consolidation.

+ Peek behind the veil

Ultimately, the value of this deal for investors may be in the information: the water projects lose money and are a payment risk. That should concern investors who hold Sound Global.

+ Valuation

We maintain our sell recommendation on SGL and keep our target price at HKD 3.48.

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Nor any drop to drink

On September 18, Sound Global (SGL) announced related-party transactions with its A-listed sister, Sound Environment (000826.SZ). According to the announcement:

- 1) SGL will issue a total of 280,373,831 new shares at HKD 8.1 per share to SE, for a total value of HKD 2.3 bln;
- 2) Sound Water, the shareholder of SGL and fully controlled by Wen Yibo and his wife, will sell 264,797,507 existing shares to SE for a consideration of HKD 2.1 bln;
- 3) SGL will purchase 100% of Hubei Yihong at a consideration of RMBD 1.2 bln (HKD 1.5 bln);
- 4) In order to purchase shares from Sound Water, Sound Environment will offer a non-public subscription of new shares.

Shares of SE resumed trading on September 29, 2014 after the company announced the details of the non-public subscription of new shares. SE will raise no more than 163,475,011 shares with a total amount of no more than RMB 3.5 bln from fewer than 10 investors. Sound Group, which owns currently 44.62% of SE, will subscribe to 30% of the new shares at a price of no less than RMB 21.41 per share. Of the total amount of RMB 3.5 bln to be raised, RMB 1.8 bln will be used for the subscription of new shares in Sound Global, and RMB 1.7 bln will be paid for existing shares owned by Sound Water.

After the deal is completed, the founder, Wen Yibo, will see his shareholding drop in both companies. The direct and indirect ownership of Wen in SGL will decrease to 41.1% from 51.3%, and his shares in SE will be diluted to 42.2% from 44.5%.

The consolidation of water assets in SGL is unlikely to benefit the company, since the 22 projects being acquired lost money in the first half, and they stand at risk of slow payment or default by government clients. The projects have total capacity of over 1.0 mln tons per day in operation, bringing in over RMB 300 mln per year. Instead, the main beneficiary is Sound Environmental, which sees the majority of its revenue from EPC for solid waste. After the

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transaction is completed, SE can focus on the faster-growing solid waste business as well as share in 31% of the profit from SGL.

In addition to Hubei Yihong, SE also made an announcement about the potential disposal of three water companies of Sound Group to SGL by end of 2017. The related three water companies are Huzhou Sound Water (300 ktpd), Hubei Jichu Water (30ktpd) and Beijing Xiaojiahe wastewater treatment company (80ktpd).

What are the water assets?

The water assets SGL is about to acquire are under Hubei Yihong, which comprises 17 wastewater treatment companies, four tap-water companies, and one pipeline and maintenance company.

The founder planned the water asset transfer to SGL from SE early this year. In May 2014, Hubei Yihong was established with a registration fee of RMB 50 mln, and water assets were injected. Based on domestic filings for Sound Environment, Hubei Yihong started to make a slight loss of RMB 6 in H1, indicating a loss from the 22 water assets in Q2. The company had reported a profit of RMB 14 mln in Q1. Net assets shrunk by 70% in three months, to RMB 322 mln at end of June, from RMB 1.0 bln at end of March. We suspect that the company incurred debt in Q2 and was burdened by interest costs.

Table 1. Key Financials of the Water Assets (In RMB000s)

In RMB000s	2013	2014Q1	2014H1
Total Assets	2,024,567.20	2,039,491.40	na
Total Liabilities	1,022,238.30	1,022,336.20	na
Net Assets	1,002,328.90	1,017,155.20	321,748.65
Total Liabilities/Total Assets	50.5%	50%	na
Total Revenue	371,500.10	83,793	na
Net Income	76,327.00	14,826	-0.006
Net Margin	20.5%	17.7%	na

Source: company data, J Capital Research

Why we don't like it

SGL started its business by providing EPC service to related parties, including Sound Environment and Sound Group, which currently owns 44.62% of Sound Environment.

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The market sees the acquisition as positive to SGL and SE, as SGL can increase its exposure in BOT projects, and both companies will have clearer differentiation. However, we think SGL will remain involved in related-party transactions with SE and Sound Group, as the company provides them with contracting services, building plants for wastewater from solid waste plants or from other businesses of SE and Sound Group.

In addition, we think adding more water management services will lower SGL's margins, as our checks show that BOT services usually have lower margins than EPC in China. Furthermore, serious delays in payment from local governments are hurting companies' cash flows. A competitor of SGL on Mainland China told us that SGL is having trouble getting local governments to pay for some projects.

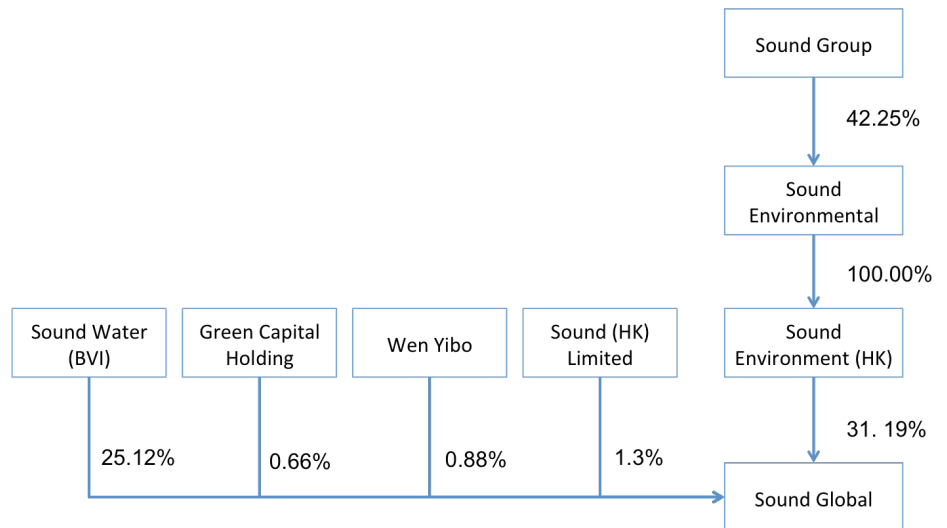
Good for Sound Environment

After selling the water assets, Sound Environment can focus on its solid-waste business. EPC for solid waste, accounting for about three-quarters of SE's total revenue, grew 28% and 72% YoY in 2013 and the first half of 2014, respectively, much stronger than the 9% and 5% YoY growth rate of the wastewater-treatment business.

Sales of existing shares by the founder

Perhaps the key issue is that company founder Wen Yibo stands to pull in HKD 2.1bn cash by selling his existing shares. Before the deal, Wen owned 51.3% of SGL through his entities, while his shareholding will decrease to 41.1% after the deal. The arrangement makes us question whether even the founder is short this company.

Chart 1. Corporate structure after the deal



Source: Company filing, J Capital Research

Valuation

Although the acquisition of Hubei Yihong will add a capacity of about 1.0 mln tons per day, about RMB 300 mln, to Sound Global's annual revenue, we think the profitability of SGL will not change significantly given the net loss reported by Hubei Yihong in 2014 H1. Instead, as risk from payment delays is rising, we think the company may have more cash flow problems than expected. We maintain our sell recommendation on SGL and keep our target price at HKD 3.48.

Risks

- Higher-than-expected order inflows following government-led environmental investments
- Stronger-than-expected water tariff hike
- Higher utilization rate of WWT plants
- Improvement of receivables collection

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