



February 17, 2014

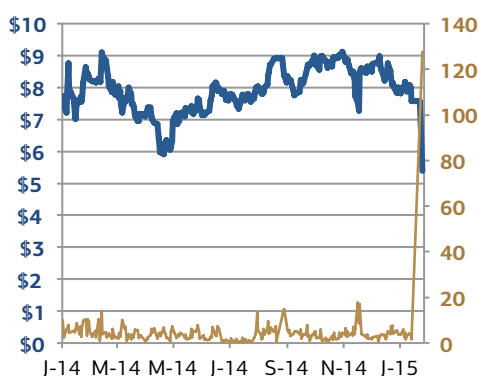
China | Water Treatment

Sound Global Ltd. (967 HK)

Anne Stevenson-Yang
+86 139 1082 0535
anne@jcapitalresearch.com

Qin Shengxian
+86 186 0026 1068
qin@jcapitalresearch.com

Sound Global (967 HK) one-year share price in HKD (blue) and volume (gold, in mln shares)



Source: Bloomberg, Feb. 17, 2015

Sound Global (967 HK)

Price	HKD 5.81
Rating	SELL
Price target	HKD 3.48
Difference	-40%
Market Cap	HKD 8.1 bln
Simple Moving Avg.	12.0 mln
Last update	Sept. 30, 2014

Source: Bloomberg, Feb. 17, 2015



What a waste

+ Still no details forthcoming

A weak response to a damaging expose published by a company called Emerson Analytics sent Sound Global's share price tumbling. The market had expected more disclosure and was disappointed.

+ A bad business—and management agrees

We continue to believe that Sound Global's margins are overstated. We believe the company is fundamentally uncompetitive and must seek projects from penurious local governments, providing BOT projects for which governments can delay payment. We find that the company has few if any higher-margin EPC projects. Management seems to agree, as they are selling shares.

+ Closing Coverage

Following the Emerson report, the company's share price has dropped by about 30%. We believe that the market will gradually do the rest. We close coverage and maintain our PT of HKD 3.48.

Too much to process

Sound Global made a clarification announcement on February 13 in response to a research report by a company called Emerson Analytics that accused Sound Global of lying about its revenue and committing accounting fraud.¹ Trading was suspended following a drop of 5.25% in the Hong Kong-traded company's shares, while its parent company, Sound Environmental (000826.SZ), saw its share price fall by nearly 16%. Sound Global responded to the report and trading re-opened, only to fall 28.9%.

“We have to keep our business secret.”

Limited Details of EPC Projects

We had expected more disclosure about the engineering procurement and construction (EPC) projects in Sound Global's response, but the company was unwilling to provide any details. The EPC projects are where the margin is supposed to be, and we noted in our initiation report that the only identifiable EPC customer is Sound Global's own parent. The secrecy contrasts with detailed disclosure of build, operate, and transfer (BOT) projects. According to the company, EPC projects are private projects and the group is not allowed to disclose the details.

“This is also in line with the common market practice in the water treatment industry in China, where detailed information of EPC projects are generally not disclosed to the public. Any disclosure of specific information of the Private Projects in public will jeopardise the relationship between the Group and the project owners.”

The difference between BOT and EPC: you get paid for EPC

We conducted checks on Sound Global EPC projects through online bidding websites, with ex-employees and some competitors of Sound Global. EPC is supposed to be the most profitable business for them and provide real cash flows to the group. However, we could find details only of the BOT projects.

Sound Global started its business as an EPC contractor to its parent companies Sound Group and Sound Environment, and we believe that most of the EPC services are still as a contractor or subcontractor to related parties. Even those projects that exist turn out to be upgrades rather than new projects.

¹ You can find the report here: http://www.emersonanalytics.co/downloads/Sound_Global_Presentation_v25.pdf

Overstated Gross Margins

Our checks show that Sound Global has overstated its gross margins. According to interviews with industrial experts, Sound Global is unlikely to have a gross margin of over 30%, as the majority of Sound Global's projects are for municipal governments.

Table 1. Gross Margins

Project Type	Gross Margins	Area
EPC	25-30%	Industrial parks
	10-15%	Municipal projects
BOT	~10%	

Source: J Capital Research

Cash-consuming business

We believe the company's main problem lies in its business model. The municipal wastewater treatment market is saturated and getting more competitive. AS a result, Sound Global has no option but to enter into the rural market. Small governments are the most cash-strapped, and they don't pay. All Sound Global can do is keep borrowing from banks by announcing new projects and using the new loans to pay back the old.

Insiders selling shares

Management began to sell a total of 1.5 mln shares in the company from late 2014.

Table 2. Selling Shares by Insiders

Date	Name of insiders	No. of Shares Sold
15/1/13	Kai Wang	-250,000
15/1/12	Liyang Luo	-230,000
15/1/8	Liyang Luo	-76,000
15/1/6	Kai Wang, Liyang Luo	-376,000
15/1/5	Kai Wang, Liyang Luo, Anping Jiang	-261,000
14/12/31	Kai Wang	-307,000
14/12/29	Anping Jiang	-15,000

Source: Company filings

Closing coverage with a sell rating

Sound Global's share price fell 28.9% on February 16 after it resumed trading in the afternoon. We are closing coverage on Sound Global. We reiterate our sell recommendation with a target price of HKD 3.48 based on a DCF method.

Disclaimer

This publication is issued by J Capital Research ("J Capital"). This publication has been prepared for the general use of the clients of J Capital and unauthorized copying or distribution is prohibited. Nothing in this document shall be construed as a solicitation to buy or sell any security or product. In preparing this document, J Capital did not take into account the investment objectives, financial situation and particular needs of the reader. Before making an investment decision, the reader needs to consider, with or without the assistance of an adviser, whether the advice is appropriate in light of their particular investment needs, objectives and financial circumstances. J Capital accepts no liability whatsoever for any direct, indirect, consequential or other loss arising from any use of this publication and/or further communication in relation to this document.