



**E-Flash Report**

**Acquisition of 20% Equity  
Interest in Derun Environment**

● **Frequently Asked Questions**

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1. Derun Environment recorded net profit of RMB349 million in the first quarter of 2017, while net profit for last year was only RMB724 million. How is Derun Environment's future profit trend? How does the Company look upon the valuation of this acquisition?

A: Described the financial data of Derun Environment first, and then analyzed the project valuation and the profit contribution to the Company.

About Derun Environment's profitability data in 2016. Derun Environment's accumulative profit from January to November 2016 was nearly RMB900 million and its annual profit in 2016 was only RMB700 million, representing a decrease of approximately RMB200 million, mainly due to the changes in the preferential tax policy of Chongqing Water, a major subsidiary of Derun Environment in the end of 2016. One of the core business of Chongqing Water, sewage business, had enjoyed the preferential policy of added-value tax ("AVT") exemption. At the end of 2016, Chongqing Water was informed by the tax bureau that it had to pay the AVT of the last 18 months, and then the tax bureau would return 70% to Chongqing Water. Under this new arrangement, Chongqing Water had to make a tax expense provision of more than RMB500 million at the end of 2016. In the first quarter of 2017, Chongqing Water paid the according tax amount to the tax bureau and received the 70% return i.e. nearly RMB400 million. The related tax expense and return information can be referred to in the public announcement of Chongqing Water. After adjustments for the above-mentioned special event, Derun Environment's normal profit in 2016 was approximately RMB1 billion, of which the Company received approximately RMB200 million according to 20% equity ratio.



About the consideration of the acquisition. The Company acquired 20% equity interest in Derun Environment with a final price of RMB4.408 billion. The transaction is expected to be finished at the end of May. The 20% equity interest corresponds to the net asset of Derun Environment in the end of May 2017, including Derun Environment's profit from January to May 2017 and dividend in 2016. If the Company receives Derun Environment's dividend of 2016 in the near future, the Company can offset the consideration of RMB4.4 billion in accounting. The case is similar to the acquisition arrangement of the Company's acquisition of Bank of Guizhou in the end of 2015. As such, the Company's book value of consideration will be lower than RMB4.4 billion. P/E ratio will be 21-22x given consideration is not higher than RMB4.4 billion and Derun Environment's annual profit is RMB200 million. Based on the expectation of development prospects of Derun Environment and its two major subsidiaries, the Company considers the P/E ratio is reasonable. From the view of another index, return on static assets, if RMB200 million profit is divided by an acquisition consideration of no more than RMB4.4 billion, the resulted return on static assets is 4.5~4.6%. Compared with the Company's existing financial position and financing cost, as well as most capital of this transaction was the Company's own deposits, the rate of return is higher than the deposit interest rate and the financing cost rate for this transaction. Apart from the Company's own deposits, the Company also adopted a small portion of short-term loans, with an average annual financing cost rate of 4.15%. In the future, the Company will consider using medium-/long-term refinancing as replacement, so that the total financing cost will not exceed 4.5% (before tax) and 3.3% (after tax). From the Company's existing net cash position, an after-tax profit return rate of 4.5% not only complies with the Company's return standard, but also forms significant supplement to the Company's existing profits.

About financial data and valuation. The profit contribution of Derun Environment in 2017 is RMB45~120 million based on the performance of 7 months, and the calculated profit is between RMB100~200 million. The difference is mainly due to the acquisition premium, i.e. how the difference between transaction price and Derun Environment's book net assets in May 2017 was treated by accounting practice. At present, the premium is estimated at more than RMB2 billion, consisting of two parts: the fair value of identifiable assets and liabilities of Derun Environment, which need to be assessed by appraisal agencies after the completion of the acquisition. 1) the difference between the fair value and the book value is a long-term equity premium to be amortized every year (similar to toll road premium); 2) the difference between the fair value and the consideration of the acquisition is goodwill to undergo impairment test every year (without provision making).



According to the Company's preliminary analysis of Derun Environment's business and assets, as well as the analysis of the composition of the acquisition and transaction price, the Company's initial judgment is that the premium is mostly made up of goodwill. Goodwill may consist of several parts: ① Derun Environment, a state-owned large enterprise in Chongqing monopolizing the regional market in Chongqing, has present and future monopoly values; ② Brand value, including the overall brand value of technical equipment and management of San Feng Environment and Chongqing Water; ③ Chongqing Water is already a listed company, including the value of Chongqing Water as a listed company; ④ The significance of the Company's transformation. Several projects of Chongqing Water and San Feng Environment (including local and national) are sustainably operating. There are differences between the valuation models of sustainable operation and toll roads' limited operation, which forms goodwill. As such, after initial judgement, the Company believes that most of the premium constitutes goodwill. It means that we believe the profit contribution of 2017 is nearly RMB200 million.

The number of more than RMB300 million in Derun Environment's data of the first quarter of 2017 contains the effects of tax adjustment at the end of 2016, and thus non-comparable factors. According to the Company's initial calculation, compared with 2016, Derun Environment maintains steady growth, which can be proved by its income (an increase of more than 4 points). But the profit cannot be analyzed simply from the data.

2. **What are the background of the acquisition and the history of Derun Environment? What is the scale? Who are Derun Environment's shareholders?**

A: Derun Environment was established in 2014. In 2015, Derun Environment finished a capital increment under the witness of the China and France Prime Ministers. There are two shareholders: Chongqing Water Asset Management Company Limited ("Water Asset") and Suyu Industry Development Company ("Suyu Industry"). Among them, Water Asset is one of the 8 investment enterprises under the direct management of the state-owned system of Chongqing, as well as a capital operation platform of Chongqing's water environmental protection industry. A large part of Chongqing's environment protection industry and most of Chongqing's operational resources are subordinated to Water Asset. At the same time, Water Asset is actively developing new business. In 2015, the total assets of Water Asset amounted RMB83.5 billion, while the net assets amounted RMB27.0 billion. At present, the





business of Water Asset is comprehensive. Chongqing Water is responsible for the water supply and sewage treatment business of Chongqing. San Feng Environment undertakes the waste incineration and handling business in Chongqing, as well as the national waste incineration business. In addition, beyond this acquisition, Water Asset is responsible for the investment, construction and operation of Chongqing's water conservancy facilities. Another shareholder is Suyu Industry. One of Suyu Industry's two shareholders, Suez Environment, is an environment company ranking the first or the second in the world, with strong technology and management ability in water affairs and solid waste management. In recent years, its business development in China and other countries went well. Suez Environment values the Chinese market. The reason for it to establish Derun Environment is that Suez Environment hopes to integrate and expand its business in Southwest China or even the whole China through the help of Derun Environment. Another related shareholder of Derun Environment is another shareholder of Suyu Industry, NWS. NWS's environmental protection assets in mainland is mainly located in Southwest China, such as Derun Environment and other joint venture companies with Suyu Industry.

There are two important subsidiaries of Derun Environment. Among them, San Feng Environment is an incineration power generation company specializing in solid waste, especially municipal solid waste. At present, the industry chain of San Feng Environment is sound, including the research and development ("R&D"), production and sales of grate furnaces (waste incineration power generation equipment), BOT franchise of waste incineration projects, and entrusted operation management of waste incineration power generation. The market share of San Feng Environment in China is in the top three. The market share of its equipment is the largest in the country. At present, the number of projects being operated by San Feng Environment is eleven, with a daily processing capacity of 14,300 tons. The growth of San Feng Environment in recent years has been fast. The number of acquired orders by far is twelve, covering important cities of the country. seven out of these 12 projects are under construction. It is expected that within 2-3 years, the production capacity of these projects under construction will be released gradually, bring clear growth to San Feng Environment's performance. For the remaining 5 projects, San Feng Environment has signed contracts with local governments and preliminary works are taking place. Another subsidiary, Chongqing Water, is a listed company undertaking the water supply business of Chongqing. Its daily water supply amounts to 2,186,500 cubic meters. Besides, Chongqing Water is responsible for sewage treatment of Chongqing. At present, it owns 49 sewage farms which can process 2,220,000 cubic meters per day. Chongqing Water undertakes the important and irreplaceable functions of water supply and sewage treatment in Chongqing. With the grow of the population in Chongqing and the demand and standard for water, we believe the business of Chongqing Water will show steady growth.



3. Do you have any guidance for the profit growth of Derun Environment in the next few years? As this investment is quite big, the Company's environmental goals may account for a larger proportion in the future. Will the Company invest in any other environmental protection projects in the near future after such a large investment?

A: We have already mentioned the nature and space of Derun Environment's profit growth. In the following, it shows the growth of Derun Environment in 2016 for your reference. For the two core businesses and assets of Derun Environment, Chongqing Water accounts for 50% and San Feng Environment accounts for 57%. Chongqing Water is at a steady growth stage now. Its profit in 2016 was 5.7% higher than that in 2015. The Company expects it to steady grow within 10%. San Feng Environment will maintain its high growth momentum in a very long time of the future. It will depend on its present development stage, such as market expansion and leading equipment capacity. For your information, the growth of San Feng Environment's revenue and net profit in 2016 exceeded 30% and 26%, respectively.

After acquiring Derun Environment, the Company hopes to go through some aspects of the traditional main business and environmental protection layout with you all. The Company established the 5-year development strategies two years ago, putting forward the upgrade of its main business and transformation and development of new industries. The Company positioned the transformation and development of new industries as overall environmental protection, of which the main contents are water treatment and solid waste treatment. After two and a half years, the Company has gained some results at upgrading the toll road business: It obtained the 25-year income right of the whole Outer Ring Project by PPP model. It acquired the remaining 45% equity interest of Wuhuang Expressway from parent company. In the beginning of this year, the Company acquired 100% equity interest of Yichang Expressway. At this strategic period, the Company has reached a new height in toll road business, including in asset size and profit contribution. At the same time, the whole management of the Company has actively implemented new industrial transformation, also known as working in the environmental protection area. Based on its judgement about the industry, the Company believes that the development space of the environmental protection industry is huge, and supportive policies from the government are strong. Moreover, the environmental protection industry is a franchise business, which is suitable for the transformation direction of the Company as a state-owned listed company with leading positions of infrastructure. The Company's strategy in development the environmental protection industry is "high starting point development and associating with industrial brands". In the past two years, the Company acquired 15% equity interest of Water Transport Planning and Design Company, which is a leading institution of water treatment and water environment planning and design, and formed a strategic league with it.



The Company also obtained some water treatment projects in the Shenzhen-Shantou Special Cooperation Area. After acquiring Derun Environment, the Company can further share the environmental protection management, technology and resources with Derun Environment, including Chongqing Water and San Feng Environment. At the same time, the Company can carry out in-depth cooperation with Suyu Industry (the second largest shareholder of Derun Environment) and Suez Environment (the largest shareholder of Suyu Industry). Eventually, the Company will form two major businesses of toll road and environmental protection. The Company's return on investment standard in environmental protection is not less than that in toll road industry. The Company is at a beginning stage in the personnel, performance, management and technology of the environmental protection industry. After acquiring 20% equity interest of Derun Environment and obtaining 15% equity interest of Water Transport Planning and Design Company, the Company will possess new capacity in developing the environmental protection industry. At last, the Company will focus on one or two sub-areas of the environmental protection market and develop more holding projects, so as to enhance the Company's revenue and performance, and achieve sustainable development in the environmental protection industry.

4. Recent news reported that San Feng Environment intends to go public. Does the Company have more information? San Feng Environment has 12 projects, of which seven are under construction, and the others' contracts have been signed. How large are the sizes of these 12 projects? Any financial data about the amounts?
- A: San Feng Environment is a relatively outstanding enterprise in the industry. At present, it has 11 projects under operation. It is understood that for the additional 12 projects, three are in Chongqing with relatively larger scales. The first one is Asia's largest Chongqing Baiguoyuan Project (4,500 tons per day) under construction; the second one is Chongqing Yulin Project (3,000 tons per day); the last one is Chongqing Fuling-Changshou Project (1,500 tons per day). Other projects under construction include Guangxi Nanning Project (2,000 tons per day) with basic operation conditions and high recognition, Guangdong Meizhou Project, Liaoning Anshan Project, and Gansu Baiyin Project. There are also 5 signed projects that are located in Xinjiang, Zhejiang Shaoxing and Chongqing. The production capacity of these 12 projects is 19,650 tons per day, and that of projects under construction is 14,100 tons per day. Upon the completion of construction, the capacity will be double. So far, we do not have accurate data of the amounts of these projects. But they are normally within the investment level of the industry. Investors can try to understand the industrial situation.

San Feng Environment is currently at the preliminary stage of IPO, with relevant work ongoing.





5. What is the debt ratio of Derun Environment? At the end of 2015, Water Asset increased its investment in Derun Environment. Is there any future capital increase plan for Derun Environment?

A: In the past few years, Derun Environment's debt ratios were relatively low at around 30% within 40%. Derun Environment's subsidiary, Chongqing Water, is a listed company with adequate cash flow and inventory. The reason for them to introduce new shareholders is not to raise capital, but to achieve mixed-ownership under the background of state-owned enterprises. The financing cost of Derun Environment is very low at 3~4% with strong financial position and financing capacity.

6. The Company acquired Derun Environment corresponding to the value of net asset of Derun Environment at the end of May 2017. Was the value of Chongqing Water calculated according to the book value or fair value?

A: The corresponding value is the net asset of Derun Environment in May 2017. In other words, the 20% equity interest acquired by the Company enjoys Derun Environment's book value of net asset in May 2017. The consideration was more than RMB4 billion. The final difference between book value and fair value will be distributed to goodwill and equity investment premium.

Derun Environment accounts for 50% of Chongqing Water and Chongqing Water's net assets attributable to the parent company are calculated at 50%.

7. The Company's acquisition is located in Chongqing. In terms of geographic location, does the Company have any consideration on Shenzhen and the Pearl River Delta region? The Company is a minority shareholder holding 20% equity interest. Will the Company consider acquire 50% or more shares of the project or other projects to become a controlling shareholder? From the aspect of long-term planning, how much do the Company's expressway main business and environmental protection new business contribute to revenue and profit? If the Company reaches a certain scale in the environmental protection industry, will it consider changing its name?

A: The importance for the Company to acquire Derun Environment is Derun Environment's industrial position, embedded value of assets and in-depth strategic collaboration between the Company and Derun Environment in the future. First, Derun Environment possesses reasonable financial returns and good growth potential, which can be seen in these aspects: 1) Chongqing Water has stable and reasonable returns; 2) San Feng Environment has good growth potential and the country's largest market share in production and sales of waste power generation equipment. In addition, in terms of geographic location, the Company mainly focuses on Guangdong and Shenzhen. As the Company lacks resources in the environmental



protection sector, when it find that the required resources are not located in Guangdong or Shenzhen, the Company will consider acquisition according to the nature of projects. We will consider geographic location as the second most important factor. The Company will first consider the embedded value of the acquisition itself and the synergy of future transformation. The Company holds 20% equity interest of Derun Environment and does not have any plans of acquiring more shares at present.

For the new environmental protection business and toll road business, the Company obtained approval to operate as a formal business both in the strategic level and state supervision level. The Company has gained leading advantages in the toll road business, and will continue to leverage its advantages in the industry. As long as it conforms to the Company's development needs, the Company will consider thoroughly the asset, so as to consolidate and further expand the industry. For the environmental protection industry, the Company is still at a beginning stage. The Company's current strategy is to cooperate with brand enterprises. After acquiring 15% equity interest of Water Transport Planning and Design Company and 20% equity interest of Derun Environment, the Company will launch a new start. In terms of assets, the Company expects that environmental protection assets will account for 20% of the Company's total assets. Under the prerequisites of fulfilling the Company's financial return of investment and taking into consideration the Company's own capacity, the Company will actively explore water treatment and waste treatment projects.

Once the Company has built a foundation of management capacity, technical capacity and personnel advantages in the environmental protection sector, it will pay close attention to the future development of holding projects. It is because as a listed company, the Company not only has to care about the growths of profit and revenue, but also consider and seek holding projects. When the Company reaches a certain stage, its name will be determined by the future.

8. The ROE of waste power generation projects is believed to be higher. What are the core advantages of San Feng Environment distinct from other industrial peers? Besides the 12 under-construction or signed projects, will the market share of San Feng Environment increase in the future? At present, San Feng Environment's market share ranks within the top three. Are the 12 signed or under-construction projects included?

A: Waste power generation is a more mature sub-sector with better growth in the environmental protection sector. The market share of San Feng Environment in this sector does not include the 12 under-construction or signed projects. Only by





its existing 11 operating projects, San Feng Environment is able to reach this rank. In the industry, this ranking has not yet formed a market pattern of oligopoly. The core advantages of San Feng Environment are its R&D and production of equipment, and investment, construction and entrusted operation of waste incineration power generation through equipment R&D, production permeation. The R&D capacity of San Feng Environment comes from the grate furnace technology from Europe, which is a leading mainstream technology in the world. Also, San Feng Environment is able to leverage its R&D and domestic patent. As such, San Feng Environment's core advantages are very important tools for market expansion in the industry. In the future, in terms of market share of waste incineration power generation, under the support of national policies, we believe the incineration rate of the household waste treatment rate will reach 50% and have aggregate demand. Also, under the current fierce competition, enterprises with self-owned technology, brands and good business performance such as San Feng Environment, will acquire more market shares.

### **About Shenzhen Expressway**

*Shenzhen Expressway was established on 30 December 1996. In March 1997, the Company issued foreign capital shares (H Shares) which were subsequently listed on The Stock Exchange of Hong Kong Limited on 12 March 1997. In December 2001, the Company issued Renminbi-denominated ordinary shares (A Shares) which were subsequently listed on the Shanghai Stock Exchange on 25 December 2001. The Company is mainly engaged in the investment, construction, operation and management of toll highways.*

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