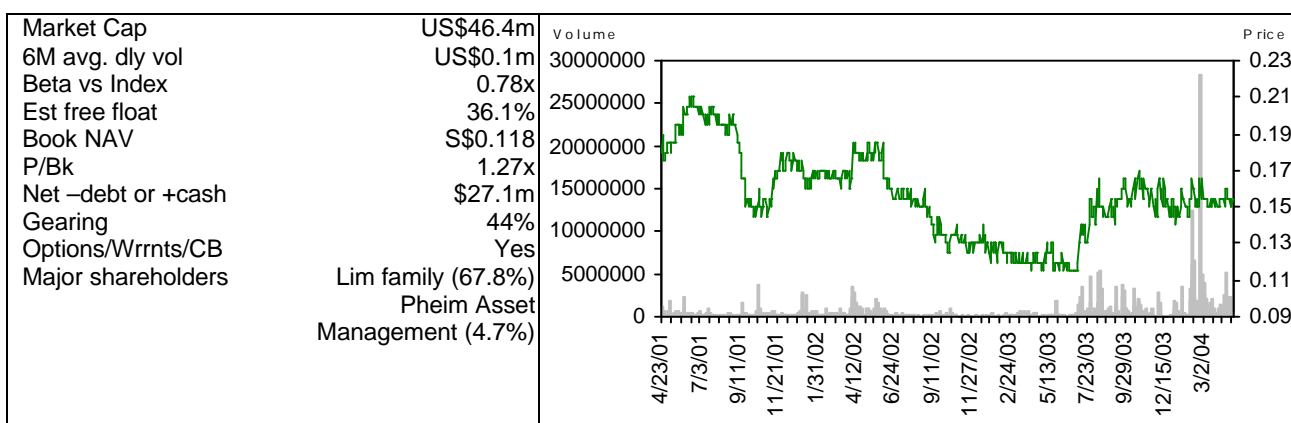


Chip Eng Seng Corp Ltd

BUY

- Construction
- Initiating coverage
- Date –27 April 04
- ST Index – 1,863.71
- Price \$0.15**
- CESE.SI
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- ◆ **Set to enjoy the rewards of its successful transformation into a contractor cum developer.** Earnings are projected to grow at an average 23% over the next three years.
 - ◆ **Earnings will be driven by the higher yielding residential development contributions,** which will boost net margin to an estimated 7.7% by 2006. The One Fort and Grandeur 8 projects, which are almost fully sold, are expected to rake in an attributable profit of \$20m when completed. Rental income from its commercial and industrial assets provides a small but stable income base.
 - ◆ **Despite the competitive operating environment,** construction activities should remain profitable due to cost efficiencies and spillover benefit from its joint venture projects.
 - ◆ **Strong cashflow management will ensure high dividend payment.** Over the past two years, the group's dividend payout ratio was a high 80-100%. We expect the group to remain generous over the next few years as progressive completion of development projects will ensure a steady stream of cash inflow.
 - ◆ **We are initiating coverage on Chip Eng Seng with a buy recommendation.** Valuations of 10x FY04 earnings is inexpensive and it offers a high dividend yield of 13.3%.

Year to 31 Dec	Sales (\$m)	Pre-tax Profit (\$m)	Net Profit (\$m)	EPS (cts)	EPS growth %YoY	PER (X)	P/CF (X)	Div Yield (%)	Net Margin (%)	ROE (%)	ROA (%)
2002	176.0	6.5	4.0	0.8	110.5	18.6	226.5	5.0	2.3	7.2	2.3
2003	159.8	11.3	8.5	1.6	100.0	9.1	11.2	13.3	5.3	13.9	5.1
2004F	148.7	12.1	9.2	1.5	-6.3	10.0	12.3	13.3	6.2	13.1	4.5
2005F	175.0	14.8	11.3	1.8	20.0	8.1	10.6	13.3	6.5	15.3	5.1
2006F	189.7	19.1	14.6	2.4	33.3	6.3	9.5	13.3	7.7	18.0	6.1



Chip Eng Seng is a Buy for its growth prospects and strong dividend yield

Investment summary

Chip Eng Seng has successfully remade itself into a contractor cum developer and is set to enjoy the fruits of this diversification over the next few years. Earnings are anticipated to grow at an average of 23% annually during this period, led by better residential development income and stable construction profits. With a strong cashflow management, dividend yield is expected to remain high at 13%.

Residential development activities will be the major growth driver due to progressive billings from ongoing projects such as One Fort and Grandeur 8 as well as new projects in the pipeline at Riviera Drive and Shanghai Rd. As development projects yield better margins than construction projects, net margin should continue expanding, thus improving the group's ROE and ROA.

Construction activities are expected to remain profitable despite the competitive operating environment with cost efficiencies and spillover benefits from joint venture projects.

Dividend payout ratio is expected to remain high, estimated at close to 100%, with strong cashflow from progressive completion of development projects.

Valuation is inexpensive, at 10x FY04 earnings. Moreover, the prospect of strong earnings growth and high dividend yield of 13.3% makes this stock an attractive buy.

Company Background

Chip Eng Seng is a leading construction cum development company in Singapore. It holds a BCA A1 general building contractor certification, which allows it to tender for public projects of unlimited value.

A leading construction and development company with exposure in the..

Founded in 1960 by Mr Lim Tiam Seng, the group started its operations as a building subcontractor for landed residential properties such as terrace houses, bungalows and shophouses. It later grew to become a main contractor for conventional landed housing.

In 1982, the group made its first foray into the HDB housing market as a main building contractor and later ventured into design and build contracts. Having built up a good track record, the company expanded along with the boom in the public housing market. It has carried out various development aspects of HDB projects such as high rise residential units including design and build units, carparks, substations, civil defence shelters, industrial units, commercial shoplots, food courts, markets and other amenities such as playgrounds. To date, it has completed 28 HDB projects comprising 14450 residential units and 165 industrial units with a total value in excess of \$1b.

Singapore public and private housing market...

In 1994, Chip Eng Seng was awarded the HDB Commendatory Award for good site safety and housekeeping performance. In 1996, it was awarded the ISO 9002 certification for its ability to establish and maintain a quality management system for building construction services.

In tandem with the boom in the private residential market during the 1990s, the group has been able to win construction contracts for private sector projects. Since 1996, the group has completed some \$7m worth of private residential projects.

In 2002, it purchased a pre-cast yard to enhance the group's competitiveness. The facility supplies to the group's own projects as well as to other contractors in the local market. In November that year, it won a \$5.5m term project to produce and deliver pre-cast components to HDB.

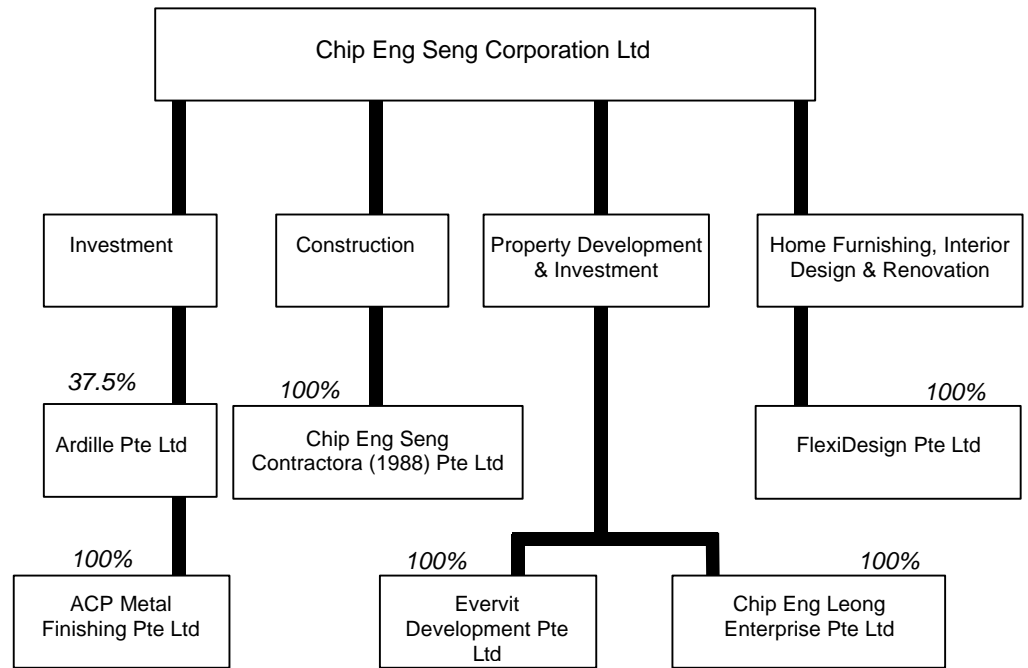
...as well as Australia

Leveraging on its expertise in the property related activities, it moved into developing private residential projects in Singapore in 2000. Since then, it has ventured into Australian property market.

In 2003, the group took a 37.5% stake in ACP Metal Finishing Pte Ltd, which is involved in surface treatment of metals, other materials and formed products.

The group was listed in November 1999, at an IPO price of \$0.18. Recently, the founding family and major shareholder, the Lim family sold 23.5m shares or 4.7% stake in the company to Pheim Asset Management at 14cts/share, bringing the major shareholder's stake down to 67.8%.

Figure 1: Chip Eng Seng Corporation Organisation Chart



Source: Chip Eng Seng 2003 annual report

Prospects

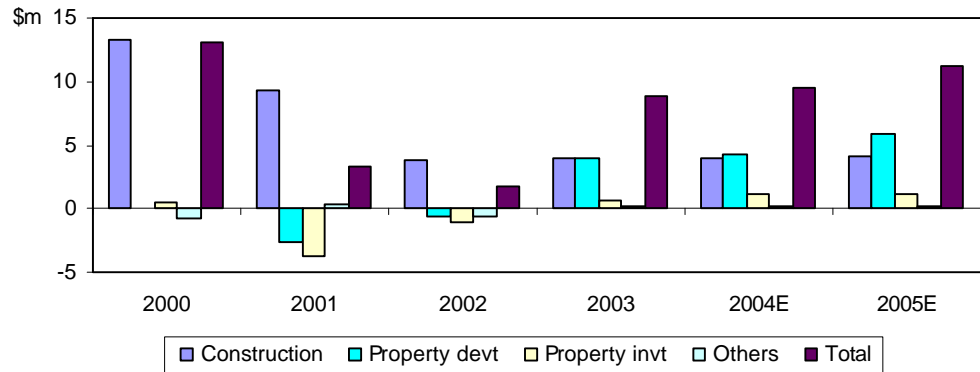
(A) Property development to drive growth and margins

Chip Eng Seng is set to enjoy a strong earnings growth path over the next two to three years, boosted by property development contributions. Growth prospects can be attributed to the group's success in re-engineering itself into a developer cum contractor.

Contributions from development activities recovered in 2003 after recording losses in 2001 and 2002 due to writedown in property values. Looking ahead, we expect the recovery to remain on track with increased contributions from its ongoing projects and new launches in the pipeline. As a result, the net profit margin is projected to improve from 5.3% in 2003 to 7.7% by 2006 as development income yields higher margins than construction.

Development activities to boost earnings

Figure 2: EBIT Breakdown 2000-2005



Source: Chip Eng Seng annual report, Kim Eng estimates

Since its first joint venture with NTUC Choice Homes to develop the 384-unit Bishan Loft executive condominium, it has progressed with several other private residential projects. We expect the group to continue to enjoy the fruits of its transformation due to the following competitive advantages.

Focussing on smaller projects

(i) Niche in quality small and mid sized developments

Based on the group's track record, it has carved for itself a strong niche in small and medium sized developments, away from the competitive market place of large projects, which are dominated by the major developers. One such example is the fully sold One Fort development at Fort Road. Other landbank in its portfolio such as Riviera Drive and Shanghai Rd are also targeted at such a market niche.

Figure 3: List of Ongoing and New Projects

Project	Location	Units	Selling price (\$psf)
One Fort	Fort Rd	79	690
Grandeur 8	Ang Mo Kio	576	475
Riviera Drive	Riviera Dr	138	Na
Shanghai Rd	River Valley	52	Na
North Shore	Adelaide, Australia	23	A\$0.9-2.4m/unit

Source: Kim Eng estimates

Leveraging on bigger partners

(ii) Ability to tie up with larger partners in bigger developments

Despite its relatively short track record in development activities, it is able to secure large projects through forming joint ventures with players with deeper pockets such NTUC Choice Homes. This ability to spread its risk broadens the scope of development it can undertake and ensure balance sheet remains healthy. For example, the group recently took a 30% share in the large 579-unit Grandeur 8 condominium development with NTUC.

Competitive landbank cost

(iii) Ability to source for landbank at reasonable prices

The group's conservative stance of tendering for land based on current cost rather than take a view on the market trend, has enabled it to source for landbank at reasonable prices, ensuring healthy margins. This is crucial to project profitability as current development margins are slim.

Strong cost management

(iv) Effective cost management gives a leading edge

Construction costs for its projects are likely to be more competitive with its flexibility to determine the amount of raw materials in any project to be used from its own pre-cast yard. Moreover, its strategy to achieve a quick turnaround time for its development sites will ensure lower financing charges and minimise drag on cashflow and working capital.

Overseas activities gives additional boost

(v) Overseas activities to contribute positively

Following the success of Pulteney Centre, a commercial development in Australia, the group has recently embarked on residential development activities in Australia with the 23 units low-rise condominium project, North Shore. The development is expected to be officially launched later this year. Priced at between A\$0.9-2.4m, about 4 units have been sold to date. Assuming an average selling price of A\$1.2m/unit, this project could rake in pre-tax profit of \$5-6m when fully sold.

Apart from Australia, it is also looking at expanding into markets such as China and India.

Small but positive impact from investment properties

Rental income to provide a stable base

Rental income from the group's commercial and industrial properties provides a stable support to the group's earnings. Over the past two years, this segment recorded EBIT losses, largely due to impairment losses as commercial and property values declined in Singapore. With the economy now on a recovery track, we do not expect such non-cash adjustments to drag on earnings.

All the group's investment properties in Singapore are ungeared, having been acquired many years back. The commercial building in Australia has positive rental carry. The buildings carry a fairly attractive net yield of 6.7%, opening more opportunities for potential monetising of these assets.

Its flagship CES Building in Ubi Crescent, is about 96% leased at an average rental rate of \$1.30psf/mth. In addition, the 60% owned office building, Putleney Centre, in Adelaide, is currently 50% occupied.

Figure 4: Investment Property Portfolio

Building	Location	Type	GFA (sf)/units
CES Building	Ubi Crescent, Singapore	Industrial	66737
Pulteney Centre	Adelaide, Australia	Commercial	24000
Perak Rd	Singapore	Shophouse	2
Tanjong Pagar	Singapore	Shophouse	2
Geylang Rd	Singapore	Shophouse/office	1
Geylang Rd	Singapore	Shophouse	3
Racecourse Rd	Singapore	Shophouse	1

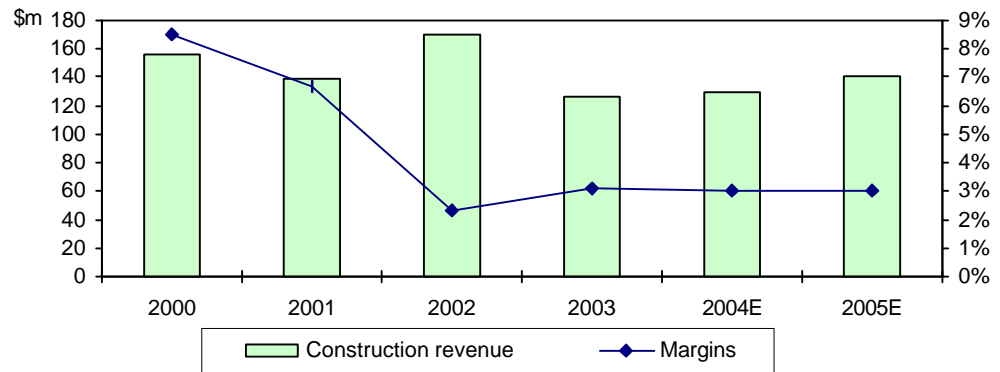
Source: Company Annual Report

(B) Construction profits to stabilise

According to the Building and Construction Authority, construction demand is projected to stabilise at around \$10-11b in 2004 after falling to a decade low of \$10b last year. Of this, \$3b is expected to come from the housing sector, with the private segment taking a 60-70% share. While we expect further consolidation to take place and margins to remain competitive, the worst is likely to be over.

Chip Eng Seng is expected to be able to withstand the competitive operating environment due to its numerous advantages of good reputation, prudent cost management and spillover benefits from its development business.

Figure 5: Construction Revenue and Margins 2001-2005



Source: Chip Eng Seng 2003 annual report

Good reputation

Reputable contractors and project manager

The difficult operating environment in the construction industry had resulted in smaller contractors not being able to finish projects on time due to financial constraints. As such, contractors with good reputation and sound balance sheet are better positioned to secure new jobs such as Chip Eng Seng.

In 1999, Chip Eng Seng won the ISO 9001, ISO14001 and OHSAS 18001 professional certification, the Good Experienced” building contractor award by HDB. It was also awarded a Certificate of Merit from the Building and Construction Authority for a public housing redevelopment project at Geylang RC 16A in 2001. A year later, it achieved a Certificate of Merit for Safety Performance given by the Ministry of Manpower for its project at Bukit Batok N3 C10.

It is a provider of a whole spectrum of services including designing, project management, even as far as interior design, which offers developers a one stop solution.

Cost efficient

Cost savings from inhouse raw materials

The group’s ability to remain profitable despite the difficult operating environment stems from its strong cost management capability, including savings from using raw materials from its own pre-cast yard.

Added benefit from JV projects

Spillover benefit from residential development activities

Since the trough in 2002, Chip Eng Seng’s order book had risen back to \$300-400m last year, coming from both private and public sector developments. The anticipated recovery in the private residential market this year is expected to generate a two pronged boost for its activities – through new third party contracting projects as developers launch more projects as well as from its own joint venture developments.

Strong cashflow

Strong cashflow to support high dividend yield going forward

Chip Eng Seng has been increasing its total dividend per share over the past few years, raising its payout ratio from 80% in 2002 to 100% in 2003. In addition to the regular 0.5cts ordinary dividend, the group paid 1.5cts in special dividend, translating to a yield of 13.3%.

We expect the group to continue to be generous in terms of dividend payout as cash inflow is expected to remain high over the next few years. The Bishan Loft project has recently received TOP. Other developments such as One Fort and Grandeur 8, which are almost fully sold, should also release more cashflow when completed. In addition, it can expect \$11-12m of cash proceeds from the conversion of its warrants expiring in June this year. The warrants are in the money and are likely to be converted. As such, there is likely to be more than sufficient cashflow, even after taking into account the group’s capex needs for replenishing its landbank.

Figure 6: Completion Schedule of Residential Projects

Project	Location	Expected TOP date
One Fort	Fort Rd	End 2004
Grandeur 8	Ang Mo Kio	3Q 2005
Riviera Drive	Riviera Dr	1Q06
Shanghai Rd	River Valley	1Q06

Source: Chip Eng Seng

Buy for growth and yield

Recommendation

The stock is a buy on account of inexpensive valuation at 10x FY04 earnings and the high prospective dividend yield of 13.3%.

Figure 7: Comparative Valuations

Company	Share price (\$)	Market cap (\$m)	P/book NAV (x)	Div Yield (%)
Chip Eng Seng	0.15	77.6	1.27	13.3
Sim Lian Group	0.26	67.3	1.18	5.6
Koh Brothers	0.11	52.8	0.61	0.9
Hua Kok	0.045	13.9	2.25	Na
Tee International	0.16	10.9	1.60	2.8

Source: Bloomberg, Kim Eng estimates

Balance Sheet

YE Dec (S\$ m)	2002	2003	2004E	2005E	2006E
Total assets	169.4	168.3	202.3	222.1	238.5
Current assets	134.0	132.8	164.5	181.5	194.8
Cash & ST investment	13.2	3.2	11.0	15.0	18.0
Development properties	49.9	59.7	72.7	80.5	93.3
Accounts receivable	35.4	33.0	38.5	43.0	48.5
Others	35.5	36.8	42.3	43.0	35.0
Other assets	35.4	35.5	37.8	40.6	43.7
LT investments	9.6	10.8	12.7	14.9	17.6
Investment properties	24.5	24.0	24.4	24.9	25.4
Others	1.3	0.7	0.7	0.7	0.7
Total liabilities	114.7	107.2	132.3	147.9	157.4
Current liabilities	90.0	82.2	102.0	112.5	118.9
Accounts payable	79.7	71.7	89.2	94.1	94.5
ST borrowings	1.3	5.6	10.0	15.0	20.0
Others	9.0	5.0	2.8	3.4	4.4
Long-term liabilities	24.7	25.0	30.3	35.4	38.5
Long-term debts	24.7	24.7	30.0	35.0	38.0
Others	0.0	0.3	0.3	0.4	0.5
Shareholder's equity	54.7	61.1	70.1	74.1	81.1
Paid-in capital	24.5	24.6	29.4	29.4	29.4
Reserve	30.1	36.5	40.7	44.7	51.7
Net tangible asset	54.7	61.1	70.1	74.1	81.1

Source: Company data, Kim Eng estimates

Key ratios

YE Dec (S\$ m)	2002	2003	2004E	2005E	2006E
Growth (% YoY)					
Sales	25.4	-0.1	-0.1	0.2	0.1
OP	39.4	1.1	0.0	0.2	0.2
EBITDA	48.8	0.9	0.0	0.2	0.2
NP	114.2	1.1	0.1	0.2	0.3
EPS	110.5	1.0	-0.1	0.2	0.3
Profitability (%)					
Gross margin	5.0	8.7	9.7	9.6	10.2
Operating margin	2.5	5.9	6.3	6.4	7.0
EBITDA margin	3.2	6.7	7.2	7.1	7.7
Net Profit margin	2.3	5.3	6.2	6.5	7.7
ROA	2.3	5.1	4.5	5.1	6.1
ROE	7.2	13.9	13.1	15.3	18.0
Stability					
Gross debt/equity (%)	0.48	0.50	0.57	0.68	0.71
Net debt/equity (%)	0.24	0.44	0.41	0.47	0.49
Int. coverage (X)	51.2	43.2	108.4	129.5	153.0
Int. & ST debt coverage (X)	3.1	1.6	0.9	0.7	0.7
Cash flow int. coverage (X)	-310.6	-58.8	44.8	-6.4	-6.4
Cash flow int. & ST debt (X)	-19.1	-2.2	1.3	-0.2	-0.1
Current ratio (X)	1.5	1.6	1.6	1.6	1.6
Quick ratio (X)	1.3	1.0	1.1	1.1	1.0
Net debt (S\$m)	12.9	27.1	29.0	35.0	40.0
Per share data (S\$)					
EPS – fully diluted	0.8	1.6	1.5	1.8	2.4
CFPS	0.1	1.3	1.2	1.4	1.6
BVPS	11.1	11.8	11.4	12.1	13.2
SPS	35.7	30.9	24.3	28.6	31.0
EBITDA/share	1.1	2.1	1.7	2.0	2.4
DPS	0.8	2.0	2.0	2.0	2.0

Source: Company data, Kim Eng estimates

Profit and loss

YE Dec (S\$ m)	2002	2003	2004E	2005E	2006E
Sales	176.0	159.8	148.7	175.0	189.7
Cost of goods sold	167.3	145.8	134.3	158.2	170.4
Gross Profit	8.7	13.9	14.4	16.8	19.3
Operating expenses	4.3	4.4	5.0	5.5	6.0
Operating Profit	4.5	9.5	9.4	11.3	13.3
Net interest	-0.1	-0.2	-0.1	-0.1	-0.2
Interest income	0.0	0.0	0.2	0.2	0.3
Interest expense	0.1	0.2	0.3	0.4	0.4
Net investment income/(loss)	0.3	0.7	0.0	0.0	0.0
Net other non-op. JV+Assoc.	4.8	2.7	2.8	3.7	5.9
Net exceptionals	-3.0	-1.4	0.0	0.0	0.0
Pretax income	6.5	11.3	12.1	14.8	19.1
Income taxes	2.5	2.7	2.8	3.4	4.4
Minority Interest	0.0	0.1	0.1	0.1	0.1
Net profit	4.0	8.5	9.2	11.3	14.6
EBITDA	5.6	10.7	10.6	12.5	14.6
EPS(Scts) – fully diluted	0.8	1.6	1.5	1.8	2.4

Source: Company data, Kim Eng estimates

Cashflow

YE Dec (S\$ m)	2002	2003	2004E	2005E	2006E
Operating cash flow	-27.0	-12.9	13.0	-2.3	-2.7
Net Profit	4.0	8.5	9.2	11.3	14.6
Depreciation & amortisation	1.1	1.2	1.2	1.2	1.3
Change in working capital	-49.0	-16.2	8.1	-7.8	-8.3
Others	16.8	-6.4	-5.5	-7.0	-10.2
Investment cash flow	-2.3	-0.2	-0.4	-0.4	-0.4
Net capex	-1.2	0.5	0.1	0.1	0.1
Change in LT investment	-1.1	-0.6	-0.5	-0.5	-0.5
Change in other assets	0.0	0.0	0.0	0.0	0.0
Cash flow after invt.	-29.3	-13.1	12.6	-2.7	-3.1
Financing cash flow	23.8	1.0	8.0	2.1	0.1
Change in share capital	0.1	0.2	4.8	0.0	0.0
Net change in debt	26.0	3.8	9.7	10.0	8.0
Change in other LT liab.	-2.3	-3.1	-6.5	-7.9	-7.9
Net cash flow	-5.5	-12.1	20.6	-0.6	-3.0

Source: Company data, Kim Eng estimates

Valuation

YE Dec (S\$ m)	2002	2003	2004E	2005E	2006E
Enterprise Valuations					
NOPLAT	4.3	11.6	12.4	14.8	17.8
Inv Cap	244.9	243.2	266.5	294.0	303.8
ROIC (%)	7.8	6.5	6.7	7.9	9.2
WACC (%)	6.1	5.8	5.9	5.8	5.6
Economic Profit	4.2	132	77	75	118
Free CF	5.5	-691	106	297	275
EV	86.7	1,287.9	1,459.1	1,302.6	1,171.9
EV/EBITDA (X)	29.7	2.7	2.8	2.2	1.8
EVA Spread	1.7	0.7	0.7	2.1	3.5

Source: Company data, Kim Eng estimates

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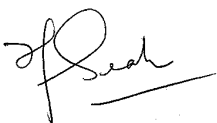
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