

### Bottom fishing at HK\$4.5

➤ **Long history and well-known by the market.** Being established in 1979, COLI is a reputable and long history red-chip company in Hong Kong. The company participated in HK property market but changed its focus to China in 1998. After that, COLI evolved and became a leading property developer in China. The projects are located in 12 first and second-tier cities in China as well as in HK and Macau.

➤ **Sizeable land bank fuels for future development.** COLI has the land bank of above 11m sqm that is sufficient for its development next 4 years. It is estimated that property completion will be reached 2.1m sqm and 3.0m sqm in 2006 and 2007 respectively. The company replenished two pieces of land in Suzhou with GFA of 447,930 sqm in 1H06. We project that revenue from property development would triple from HK\$6.0 bn in 2005 to HK\$19 bn in 2008. Furthermore, we expect that large and reputable property developers would gain the market share in this period of austerity measures.

➤ **Become a pure property player.** COLI plans to dispose its infrastructure business to its shareholders in coming year. Focusing on property business would enable investors having a clear vision and valuation on the company. Since infrastructure business only represents about 3% of our appraised NAV, this disposal would not significantly affect the earnings of COLI.

➤ **Positive factors have been priced-in but bottom fishing at HK\$4.5.** Using sum-of-the-parts method, NAV of COLI is estimated to be HK\$5.66 per share. Since share price of COLI rebounded by 25% from the tough in 2Q06, all positive factors have been priced-in. The counter is trading at 12% discount to our estimated NAV. We believe the valuation is rich. Our target price is HK\$5.1, representing 10% discount to NAV. Recommendation is HOLD. But we recommend the investors re-enter at HK\$4.5.

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Industry	China Properties
Price	HK\$ 5.00
Target price	HK\$ 5.10 (+2.0%)
Stock code	688
Market cap.	HK\$34,533mn
O/S shares	6,906mn
52wk high/low	HK\$ 6.05/1.81
NAV per share	HK\$5.66
Major shareholder	China Overseas Holdings (53.2%)

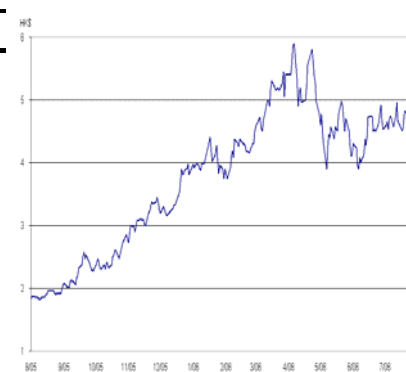
HK\$1=RMB1.03

### Earning Summary

Year-end 31 Dec	FY04A	FY05A	FY06E	FY07E	FY08E
Turnover (HK\$ m)	5,308	6,971	13,262	18,292	20,064
Growth (%)	-30	31	90	38	10
Net Profit (HK\$ m)	1,074	1,535	2,397	2,994	3,500
Growth (%)	56	43	56	25	17
EPS (HK\$)	0.171	0.24	0.361	0.422	0.479
Growth (%)	34	40	51	17	13
PER (x)	29.3	4.7	13.9	11.8	10.4
DPS (HK\$)	0.06	0.07	0.1	0.12	0.13
Yield (%)	1.2	1.4	2	2.4	2.6

Source: Company information, FSSL

### Price Performance



Source: Bloomberg

## Hong Kong Experience

### *Over 27-year history*

Established in Hong Kong in 1979, China Overseas Land & Investment Ltd (COLI) is one of the long history red-chip companies in Hong Kong. It went to public in 1992. In the initial stage, COLI mainly focused on the construction business and was the major contractor of the government projects, such as public housing and civil engineering. In the same moment, the company also participated in Hong Kong property development business. After the Asian crisis and the booming of China property market around 2000, COLI shifted its focus to China from Hong Kong. Now, it is one of the leading property developers in China.

### *Gain experience in HK*

Hong Kong property market boomed in 90s. During this period, property developers evolved into a new stage. Marketing skill, product design and building technique improved substantially in 90s. Although COLI is a small property player in Hong Kong, the company would join hand in hand with other major developers so that COLI could learn the management know-how and other skills for property development. The company jointly developed several projects (such as Dynasty Height, Olympian City and Regalia Bay) in Hong Kong with other Hong Kong major property developers.

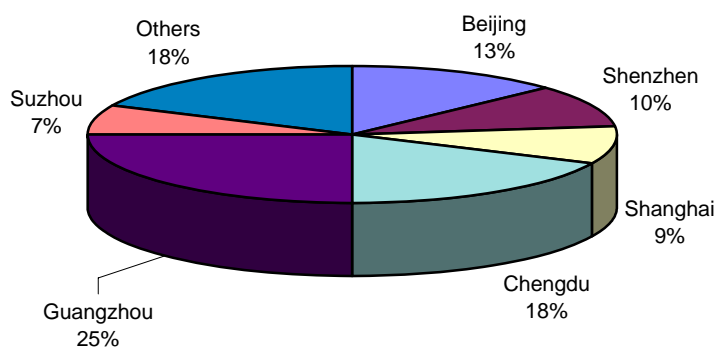
## Major Developer in China

### A national player

### *A leading developer with national land bank*

The company has changed its strategy since 1998. Due to the sluggish performance of Hong Kong property market after the handover, COLI decided to make more effort to explore the market in China. Now, COLI is a leading property developer in China with land bank of above 11m sqm. These projects are located in 12 first-tier and second-tier cities in China as well as in Hong Kong and Macau.

**Figure 1: COLI's Land Bank in terms of GFA**



Source: Company information

*Land bank for 4 years*

Because of the sizeable land bank, we believe that it is sufficient for its future development in coming 4 years. It is estimated that 2.1m sqm and 3.0m sqm of development properties will be completed in 2006 and 2007 respectively. In 1H06, the company replenished two pieces of land in Suzhou with GFA of 447,930 sqm into its land bank. Accommodation value is about RMB 3,081 sqm.

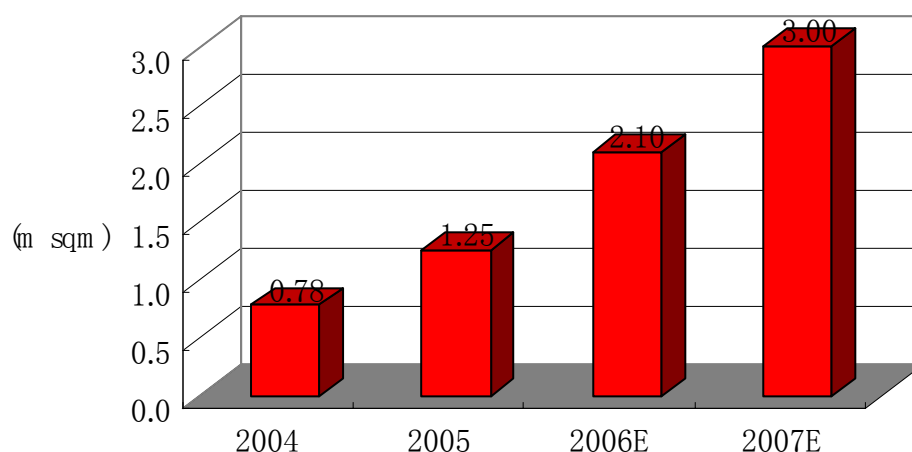
*Top 10 developer in China*

Furthermore, the company is ranked as the one of the top ten property developers in China by the Top 10 China Real Estate Research Group. We believe the reputable brand name could bring the customers with confidence and facilitate its sales progress. Especially, we believe that the large and reputable property developers gain advantage in the recent austerity measures. On the one hand, they can replenish the land bank in the lower cost. On the other hand, property buyers would like to purchase quality properties if they are affordable.

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**Figure 2: Property Development Completion Schedule**

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Source: Company information

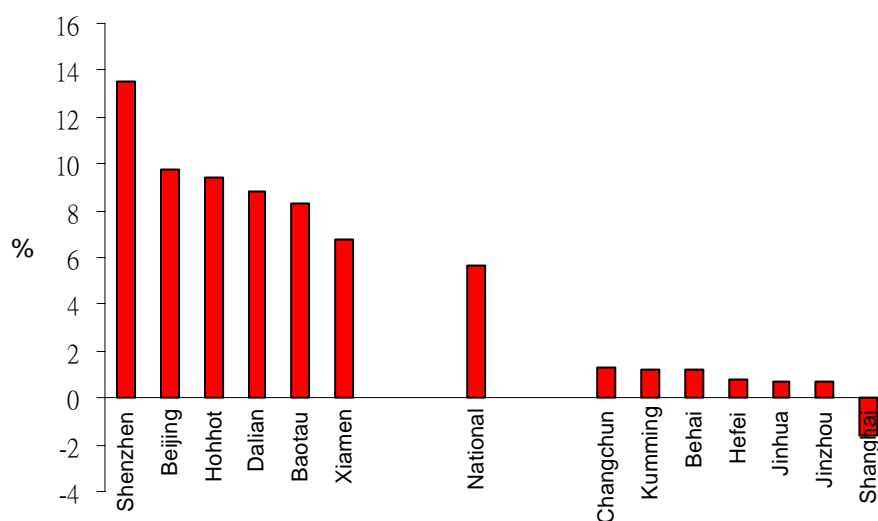
## Diversification reduces the risk

*Risk minimization due to the national coverage*

COLI is distinct from other mainland property developers. Its land bank is widely spread over China. Thus, it can reduce the risk by diversification. The Central government delegates municipal governments to manage 70%/90 sqm rule. Some cities (such as Shenzhen and Dalian) implement a stringent rule of limiting the development of less than 90 sqm apartments in more than 70% of overall development plan while others (such as Guangzhou and Hangzhou) have a looser rule.

*Overall property price rose by 5.7% yoy in July*

According to the latest statistics from National Development and Reform Commission, the PRC, the national property price index increased by 5.8% yoy in July 2006. For particular cities, property price index in Shenzhen, Beijing, Hohhot and Dalian surged by 13.5%, 9.8%, 9.4% and 8.8% yoy respectively in July 2006 but that in Shanghai fell by 1.6% yoy in the same period. Thus, we see that the property bubble in China is not as serious as we imagine except in a few cities.

**Figure 3: China Property Price Index in July 2006 (YoY change)**

Source: National Development and Reform Commission

*Overall property market in China was mild but recent austerity measures affects sentiment*

As the national average of China Property Price Index advanced by 5.7% yoy in July 2006 and household income in urban area of China surged by 11.6% in 1H06, we believe the overall property market was under control except in several cities in China. However, recent austerity measures would scare the property buyers in China, especially in the short-term in some cities. Therefore, we believe choosing a company with diversification in the property portfolio is a better strategy for investors to reduce the risks.

### Macau project secures the earning in 2007

*Macau project provides HK\$1 bn plus profit*

According to the general practice, property developers would pre-sell their properties 12 months before the completion. Thus, we see that the latest austerity measures would not have any significant impact to 2006 earnings. The uncertainty for the earnings would be arisen in 2007 and afterwards. However, COLI may reduce the earning invisibility in 2007 because its project in Macau (la Cite with GFA of 104,316 sqm) would contribute over HK\$1 bn profit to COLI in 2007.

*Plans to be top 5 developer in Macau*

Since COLI understands its positioning, it will make more effort in exploring the markets in China and Macau. Beside China market, COLI would like to be the top five property developer in Macau next five years. Following the liberalization of gaming industry a few years ago, Macau economy grew robustly. We expect COLI would replenish the land bank in Macau in future in order to develop the business in Macau. As at June 2006, land bank in Macau accounted for 1.7% of total land bank or 3.9% of NAV.

# Pure Property Player in Future

## Unload infrastructure operation

*Disposed construction business in 6/05*

COLI disposed its construction business and distributed the shares to the shareholders in June 2005. China State Construction Int'l Holdings Limited (CSCI, 3311 HK) commenced to trade on the Stock Exchange of Hong Kong by way of introduction. The shareholders, who owned every 18 shares of COLI, would receive 1 share of CSCI. Then, COLI stopped engaging in construction business. In the coming year, the company plans to dispose its infrastructure business to its shareholders. After the disposal, COLI will become a pure property company.

*Plans to dispose infrastructure business to shareholders*

COLI's infrastructure business (included subsidiaries and associates) contributed EBIT of HK\$74m in 2005. We estimate its value to be HK\$1,184m, based on 16x EBIT. Since the size of infrastructure business is not significant (represents 3% of our appraised NAV), we believe that spin-off of infrastructure business would not adversely affect the operation of COLI. In contrast, the market can have a clear perception and valuation for COLI if the company positions itself as a pure property player.

## Establish an investment properties portfolio

*Rental income is insignificant now.....*

Currently, rental income accounts for 1-2% of total revenue or investment properties represents 5.7% of our appraised NAV. Thus, rental income is not the main income source of COLI. However, the company understands that holding Grade "A" offices in the portfolio would reduce the operational risk and receive stable rental income. Therefore, COLI would build up its investment properties portfolio in the future. The company owns 66,265 sqm investment properties now. We believe that it will spend another 5 years for COLI to have a substantial investment properties land bank.

*... but will account for 20% of total profit after 5 years*

Champion Court in Beijing will be completed in 2006. GFA is about 24,600 sqm. COLI would retain Champion Court as an investment property. Since Champion Court is located at the financial area of Beijing, daily rental can be as high as US\$1 per sqm. Furthermore, other investment properties in Beijing and Shanghai will complete the construction in 2007 and 2008. Then, investment properties are expected to enhance by 260,000 sqm and rental income will account for 20% of total profit after 5 years.

# Healthy Balance Sheet

*Net gearing ratio was 39% in 2005*

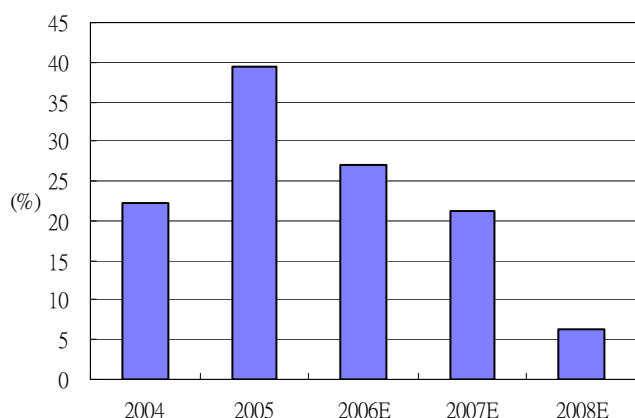
Net gearing ratio of COLI was 39% in 2005. It was sound compared with the peers. In order to strengthen the shareholders' fund, COLI declared to issue the warrants to the shareholders. The warrants are last for one year and going to expire on 18<sup>th</sup> July 2007. Exercise price is HK\$4.5 and total proceeds will be HK\$3,648m if all warrants are exercised.

We see that there will be many opportunities for merger and acquisition activities or land replenishment after the launch of new austerity measures. Raising fund through warrant would, on the one hand, enlarge the capital for business expansion. On the other hand, shareholders have the same right to participate in the growth of the company.

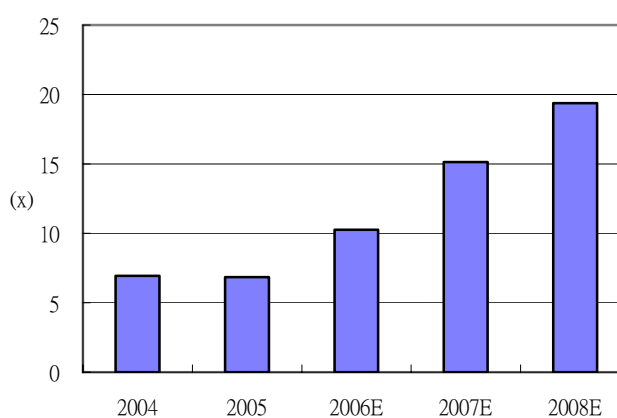
*Controlling shareholder exercised the warrants*

According to the controlling shareholder's announcement, China Overseas Holdings Limited had already exercise the warrants to subscribe 408m new shares in the sum of HK\$1,837m in July 2006 and its stake in COLI increased to 53.2%. This shows a confidence to the company's future.

**Figure 4: Gearing Ratio**



**Figure 5: Interest Coverage**



Source: Company information, FSSL

Source: Company information, FSSL

## Earning & Valuation

*Property completion is expected to surge to 3m sqm in 2007*

The earning driver of COLI is property sales. GFA for property development is estimated to soar from 0.78m sqm in 2004 to 3.0m sqm in 2007, representing a CAGR of 55% in 2005-07. As the volume grows, revenue from property development is estimated to triple to HK\$19,068m in 2008 from HK\$5,992m in 2005. Although we have discounted the disposal of infrastructure business in mid-2007, it would not have the great impact to COLI's earnings as infrastructure represents insignificant amount of revenue to COLI.

*Conservative assumption*

We adopt a conservative revenue booking method to reflect the uncertain environment of Mainland property market. Details can be found in the following table.

**Table 1: Revenue Booking Assumption for Property Development**

	Existing properties	Completed in		
		2006	2007	2008
Booking in 2006	80%	80%	-	-
Booking in 2007	20%	20%	70%	-
Booking in 2008	-	-	30%	70%

Source: FSSL

*Contracted sales is estimated to be HK\$16.8 bn in 2006 & HK\$26.0 bn in 2007*

Although China tightened its housing policies in April-May 2006, the earnings of COLI in 2006 would not be adversely affected because most of the properties completed in 2006 had already been sold out. COLI completed the contracted sales in the amount of HK\$12.1 bn in 2005. It is expected that contracted sales would be HK\$16.8 bn and HK\$26.0 bn in 2006 and 2007 respectively. Because of the surge in the completed properties in coming 2 years, we forecast that revenue from property development would jump to HK\$12.2 bn in 2006 and HK\$17.3 bn in 2007. Furthermore, rental income is expected to rise by more than 20% in 2007 and 2008 because new office building in Beijing will be completed in 2007 and contribute full year earnings in 2008. Rental income is estimated to be HK\$217m by 2008.

**Table 2: Revenue Breakdown**

(HK\$ m)	2004	2005	2006E	2007E	2008E
Property development	4,639	5,992	12,187	17,261	19,068
Property investment	134	128	136	171	217
Infrastructure	265	300	338	180	0
Other	270	552	600	680	780
Total revenue	5,308	6,971	13,262	18,292	20,064

Source: Company information, FSSL

*Net profits estimate to be HK\$2.4 bn in 2006 & HK\$3.0 bn in 2007*

We project that net earnings will be HK\$2,397m and HK\$2,994m in 2006 and 2007 respectively, of which associated income of HK\$367m in 2006 and HK\$92m in 2007 are arisen from No. 1 Honey Lake project.

*Target price is HK\$5.1, 10% discount to NAV of HK\$5.66 per share.*

Using sum-of-the-parts valuation method, we estimate that NAV of COLI is HK\$5.66 per share. The counter is trading at 11.7% discount to our estimated NAV. Although COLI is the market leader, we believe valuation is already priced-in its positioning. Our target price is HK\$5.1, representing 10% discount to our estimated NAV.

*Bottom fishing at HK\$4.5.*

Our target price represents 2% upside potential. Thus, we have a **HOLD** recommendation. However, we still believe COLI will gain the advantage in this period of austerity measures as the company will replenish the land bank in a lower cost and buyers will buy the properties from reputable developers. Therefore, we advice the investors can do bottom fishing at the price around HK\$4.5.

**Table 3: NAV estimation**

	(HK\$m)	NAV per share (HK\$)	% of NAV	Remark
Development properties	37,684	5.46	96.40%	DCF with WACC 11.0%
Investment properties	2,236	0.32	5.70%	Cap rate of 5-10%
Infrastructure	1,184	0.17	3.00%	16x EBIT
Other business	528	0.08	1.40%	6X EBIT
Gross Amount	41,632	6.03	106.50%	
Add: Warrant exercise	1,837	0.27	4.70%	
Less: Net debt	-4,374	-0.63	-11.20%	
NAV	39,095	5.66	100.00%	

Source: FSSL

## Risk

**Interest Rate Risk.** Due to the huge inflow of Foreign Direct Investment and robust growth of M2 in China, it is expected that China will raise its interest rate again after 0.27% hike in April 2006. Thus, it may affect the market sentiment and increase COLI's interest expense.

**Further austerity measures.** Chinese Government had introduced several measures to control the property market recently, such as issue rules on foreign people investing China properties, set up regional bureaus monitoring land sales and enforce a 20% capital gain tax for property trading. We are afraid that further administrative policy would seriously dampen the market sentiment.

**Appreciation of RMB.** After China widened trading band in July 2005, RMB was appreciating past 12 months. Now, it is trading at US\$1 to RMB 7.98-8.0, compared with RMB 8.28 one year ago. Since majority of COLI's assets are in China, appreciation of RMB would bring positive effect to COLI's valuation and earnings.

**New accounting rule for investment properties valuation.** HKAS 40 "Investment Property" states that the company should use the fair value model to account for its investment properties which requires gains or losses arising from changes in the fair value of investment properties to be recognized directly in the profit or loss for the period in which they arise. Thus, it may be result in the volatility in the earnings forecast of the properties companies. However, this kind of uncertainty does not result in any effect to the cash flow and NAV valuation method because it is a non-cash item.

**Global economy slowdown.** It may result in global economy slowdown if high oil price sustains at a longer period. Then, China economy will suffer and in turn adversely affect Mainland property market.

**Table 4: Completion schedule**

## Existing projects

Project	Interest	GFA (sqm)	Selling Price (HK\$/sqm)	Cost (HK\$/sqm)	Revenue (HK\$m)	Total cost (HK\$m)	Gross Profit (HK\$m)
Der Rhein Phase II, Changchun	79%	63,409	6,000	4,000	380	254	127
Class Palais Phase I, Xi'an	100%	97,936	6,000	3,500	588	343	245
Seine Elysee Zone A, Nanjing	79%	17,249	6,000	3,500	103	60	43
St. Andrew Phase I, Beijing	75%	18,520	10,000	6,000	185	111	74
Marbella Villa, Changchun	79%	185,742	4,500	3,000	836	557	279
		382,856			2,093	1,325	767

## In FY06

Project	Interest	GFA (sqm)	Selling Price (HK\$/sqm)	Cost (HK\$/sqm)	Revenue (HK\$m)	Total cost (HK\$m)	Gross Profit (HK\$m)
The Crescent, Shenzhen	100%	101,300	5,800	4,000	588	405	182
One Honey Lake Phase II, Shenzhen	50%	65,450	40,000	18,000	2,618	1,178	1,440
Greenery Height Phase I, Shenzhen	100%	30,282	4,500	3,000	136	91	45
Royal Green Phase I, Shenzhen	100%	8,539	4,000	3,000	34	26	9
St. Andrews Phase II, Beijing	75%	106,646	10,000	6,000	1,066	640	427
Champion Court – Office*, Beijing	100%	24,614	-	-	-	-	-
Glorious Plaza, Guangzhou	100%	32,291	12,000	8,000	387	258	129
Top View, Guangzhou	100%	146,024	9,300	6,800	1,358	993	365
Bay Line Phase I, Shanghai	99.5%	191,850	13,000	9,000	2,494	1,727	767
Greenwich Village Area B, Chengdu	100%	179,761	4,500	3,000	809	539	270
Int'l Community Phase I, Chengdu	100%	202,795	4,000	2,500	811	507	304
Longwan Bandao Phase I, Chengdu	100%	106,332	4,000	2,800	425	298	128
Lakeside Palace Phase I, Suzhou	100%	42,915	6,500	4,000	279	172	107
Royal Peninsula Phase II, Suzhou	100%	36,510	8,000	5,400	292	197	95
Bellagio Phase I, Ningbo	100%	73,163	7,000	5,000	512	366	146
Villa Marbella Phase III, Changchun	79%	159,849	4,500	3,000	719	480	240
Der Rhein Phase II, Changchun	79%	95,139	6,000	4,000	571	381	190
Nan Diquai Phase I, Changchun	100%	54,497	4,800	3,200	262	174	87
Starcrest Phase I, Foshan	100%	215,158	4,500	3,200	968	689	280
Fairland Phase IB, Zhongshan	100%	26,241	4,000	2,500	105	66	39
Classic Palais Phase II, Xi'an	100%	146,998	6,000	3,500	882	514	367
Seine Elysee Zone B, Nanjing	79%	55,283	8,000	5,600	442	310	133
		2,101,637			13,142	8,831	4,311

Source: Company information, FSSL

\* Retain as investment property

**Table 5: Rental income**

(HK\$ m)				2006E	2007E	2008E
Project	Interest	Usage	GFA (sqm)	Rental	Rental	Rental
China Overseas Bldg, Wanchai	100%	Comm/CP	20,230	68.8	79.4	87.8
Hai Fu Warehouse	100%	Godown/Comm	26,487	21.9	21.9	21.9
Hai Xing Plaza, Shanghai	51%	Commercial	4,939	10.8	12.1	13.5
Dongshan Plaza, Guangzhou	100%	Commercial	10,972	23	24.2	25.5
Horae Place, To Kwa Wan	100%	Commercial	3,637	12	12	12
Champion Court, Beijing	100%	Office	24,600	0	21	55.9
<b>Total</b>			<b>90,865</b>	<b>136.5</b>	<b>170.6</b>	<b>216.6</b>

Source: Company information, FSSL



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