Corporate Flash

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Andes Cheng
(852) 2533 3721
andescheng@softbank.com.hk

China Gas Holdings: Demanding valuation

Recommendation: SELL (Initiating coverage) — China Utilities

Price	**HK$1.58**
Target price	HK$1.34 (-15.2%)
12 mth range	HK$1.14-1.83
Market cap.	US$623.2m
Daily t/o, 3 mth	US$3.2m
Free float %	48.0%
Ticker	0384.HK/ 384 HK

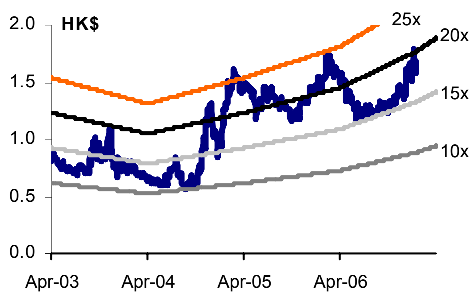
Year to Mar	Net profit HK$m	EPS HK$	EPS Δ%	P/E x	P/B x	EV/EBITDA x	Yield %	ROE %	ROCE %	N. Gear. %
05A	96.6	0.052	(14.8)	30.2	3.6	38.8	-	13.0	5.2	77.1
06A	156.7	0.061	17.4	25.7	2.5	30.2	0.6	11.0	4.6	34.8
07F	216.5	0.072	17.9	21.8	2.1	13.3	0.7	10.5	4.4	41.9
08F	305.0	0.094	30.1	16.8	1.8	11.8	0.9	11.9	5.4	52.2
09F	369.5	0.114	21.1	13.8	1.6	10.1	1.1	12.1	5.7	52.5

Relative to Hang Seng Index (1 mth, 3 mth, 12 mth):- 5..0%, +11.5%, -12.3%
Actual price changes (1 mth, 3 mth, 12 mth): -2.5%, +21.5%, +9.0%
Consensus EPS (07F-08F): HK$0.071, HK$0.085

Key points:

- Three-year earnings and EPS CAGR projected at 33.1% and 22.9%, respectively.
- Revenue from gas sales to increase as new projects start to contribute.
- Impact from a possible nationwide ban on connection fee collection.
- CNG stations to drive growth.
- Move upstream through the acquisition of a gas field and investment in an LNG plant.
- Diversified shareholder structure.
- Rich valuation against the sector average, in terms of P/E.

Chart 1: P/E bands



Source: SBI E2-Capital

Increase in number of customers. By December 2006, China Gas Holdings (the group) secured exclusive operating rights to piped natural gas projects in 54 cities and districts, as well as four long distance gas pipeline projects and one LNG liquefaction project. In 1H FY03/07A, the total numbers of its residential customers surged 125.1% YoY to 1.06m households, industrial customers 138.9% YoY to 86 and commercial customers 1,292.8% YoY to 7,382. So far in this fiscal year, the group has acquired pipelined gas projects in six cities and districts, namely Wuweixian project, Anhui province; Dezhou City project, Shangdong province; Wushen and Hohhot City projects, Inner Mongolia Autonomous Region; Qingdao City project, Shangdong Peninsula and Fushun project, Loaoning province. We estimate that the projects will provide 1.5m household customers and 2,600 commercial and industrial customers to the group. We expect the number of users in the cities to increase thanks to the robust local economy and relatively low penetration rate. By the end of FY03/07F, the group's number of residential, industrial and commercial customers should reach 1.4m, 96 and 7,382, respectively.

Industrial users consume most of the gas. Industrial users are vital for the group, accounting for about 66.8% of its pipelined gas sales. We expect them to remain the major source of revenue as they consume 3,287.8 cubic meters of gas per day, compared with 0.06 cubic meters per day consumed by households, according to our estimates. Besides, the pricing mechanism for industrial and commercial users is more flexible than that for households. In most cases, the supplier and user negotiate the price of natural gas sold to industrial users. Thus, the supplier can respond to any rise in the sourcing price (wellhead price) promptly by increasing the tariff. The price of natural gas sold to households is determined by local price control administrations. Any hikes must be approved by a public hearing.

Household users could be a drag. China's rapid industrialization and urbanization is boosting gas demand but the growth in supply is lagging behind, with some cities unable to meet their gas consumption needs. According to the statistics compiled by British Petroleum, China's natural gas production increased at a five-year CAGR of 13.0% between 2000 and 2005 while consumption rose 14.4%, in the period. In 2004, natural gas accounted for 2.6% of China's total energy consumption, coal for 67.7% and petroleum 22.7%. As the government plans to increase the proportion of natural gas consumption in the country to 10.0% by 2020, demand for natural gas will increase rapidly, boosting the wellhead price. In our model, we assume a 2.2% annualized increment in the wellhead price, which gas distributors won't be able to pass to end users because of the current inflexible pricing mechanism for residential natural gas. Besides, the opportunity cost of increasing the supply to households is high. Since natural gas is a scarce resource, any increase in supply to residential consumers will mean a drop in supply to high-volume industrial and commercial users.

Connection fee remains vital. Although the sales to households and commercial users accounted for 16.2% and 9.7% of the total gas sales, respectively, the segments, especially residential users, are the major contributors of connection fee income. In 1H FY03/07A, the group connected 62,417 domestic households, 13 industrial customers and 133 industrial users, with connection fee income representing 32.9% of the group's turnover in 1H FY03/07A, down from 50.1% in the year-earlier period. Nevertheless, operating profit of the pipeline construction accounted for 67.2% of the group's total operating profit given its lucrative gross profit margin, which exceeded 70.0%. Despite the abolishment on 27 December 2006 of gas connection fees in Guangdong, we don't expect any significant impact, as the group's exposure in the province is limited to operating rights in Maoming and Conghua. However, if other Chinese provinces follow suit, the group and most of the HK-listed natural gas distributors will be affected because the large proportion of their operating profit is derived from connection fees.

CNG will serve as the next growth driver. Since the ASP of compressed natural gas (CNG) is higher than that of pipelined natural gas, it commands a higher gross profit margin, by our estimation. Local Price Control Administrations set natural gas prices based on the price of substitutes. Since petroleum product prices are relatively high, natural gas for vehicle use tends to be priced higher. On the other hand, natural gas for households and industrial usage is priced lower, as coal and electricity are relatively cheap in China. CNG stations are expected to be the next growth catalyst of the group. We expect the number of the group's CNG stations to expand rapidly. Through the acquisition of projects in the Inner Mongolia Autonomous Region, the group obtained 10 CNG stations. Also, the group will set up four CNG stations in Changsha City through its 70.0:30.0% JV with Changsha City LPG Development. We estimate that by the end of 1Q 2007, the group will have 20 CNG stations, from six in the year-earlier period. Changsha is expected to be the growth spot of the group's CNG sales, thanks to the "Chansha City Gas Vehicles and Refilling Facility Plan" introduced by the local government. Currently, the city has 2,700 buses and 6,000 taxis. Under the plan, 65.0% of all buses and 50.0% of taxis must be fuelled by CNG by 2010 and all vehicles by 2020. To meet the anticipated surge in demand, 75 CNG stations will be set up between 2007 and 2020.

Upstream move. To secure its source of natural gas, the group is expanding vertically into upstream production and exploration and acquired 38.7% of Chongqing Ding Fat Industries for RMB62.2m. The company is engaged in the exploration and production of natural gas and operates 40 natural gas wells with the total annual production of 150m cubic meters. Chongqing Ding Fat also has a supply agreement with PetroChina (857 HK, HK$9.79, NR), which produces gas in the same region. The group has also invested RMB800m to build a 100.0%-owned liquefied natural gas project in Chongqing with an annual production capacity of 450m cubic meters. The project's natural gas supply is guaranteed by the government of Kaixian, Chongqing City. Kaixian's LNG storage capacity is estimated at 400m cubic meters per annum. Chongqing Municipality is one of China's main natural gas areas, and the source of gas for the Sichuan-East gas transmission project. Synergy is expected between the group's gas E&P project and the LNG project, which is expected to commence operation in 2008.

Our earnings forecast. We expect the group's net earning to increase at a three-year CAGR of 33.1% in FY03/06A and FY03/09F, against a 63.5% increase in turnover, on the back of 1) contribution from its newly-acquired city pipelined gas projects; 2) increase in the number of CNG stations; 3) contribution from the LNG plant from FY03/08F onwards and 4) low effective tax rate. As the newly acquired city pipelined gas projects will come start operation in the near future, we expect the group's gas sales volume to increase at a three-year CAGR of 44.4%. Income from pipeline connection will remain vital, accounting for more than 50% of the group's turnover between FY03/07F and FY03/09F. We project that the LNG plant will generate revenue of HK$74.3m in FY03/08F and HK$178.2m in FY03/09F. Sales at CNG stations should increase at a three-year CAGR of 45.0%, on the 150.0% increase in the number of CNG station between FY03/07F and FY03/09F.

Effective tax rate to rise. Most of the group's subsidiaries are exempt from China's enterprise income tax for two years after their first profitable year of operation. Thereafter, they are entitled to a 50% relief for the next three years. Thus, in our model, we calculate the effective tax rate at 2.5% in FY03/07F, 3.0% in FY03/08F and 5.0% in FY03/09F. However, the State Administration of Taxation aims to standardize the enterprise tax rate for foreign and state-owned enterprises at 25.0% by 3Q 2007F. Thus, we expect the group's new projects acquired after 3Q 2007 to be subject to an enterprise rate of 25.0%.

Share capital increase. As of the end of 1H FY03/07A, the group had 2,924.2m shares outstanding. In October 2006, it issued 150.0m shares to the Asian Development Bank at HK$1.25 each. It also issued US$40.0m worth of convertible bonds at an exercise price of HK$1.731 each to Quantitative Strategies Master Fund and Courtenay Enterprises Limited in June 2005. As of the end of 1H FY03/07A, the group had HK$277.7m worth of convertible bonds outstanding. In our model, we assume the convertible bonds will be converted into 180.2m shares and the group's total share capital will increase to 3,234.6m shares by the end of FY03/08F.

Diversified shareholding structure. The group has a diversified shareholding structure, which, in our view, facilitates the monitoring of the management and corporate governance and the protection of the minority shareholders' interests. It also allows it to capitalize on its partners' strength in capital markets, treasury and business development. Its management owns 8.1%, Sinopec 6.8%, Strait Finance 11.1%, Gail 6.8%, Oman Oil 6.8%, Asian Development Bank 4.9%, and Mackenzie Finance Group 7.5%.

Rich valuation. With its three-year earnings CAGR of 33.1%, the group is a high-growth China utility play, in our view. Nevertheless, trading at a P/E of 21.8x for FY03/07F and 16.8x for FY03/08F, its valuation is demanding, compared with the sector's average P/E of 17.3x for FY12/07F and 14.2x for FY12/08F. Its rich valuation is unjustified due to its relatively low ROE projected at 10.5% in FY03/07F and 11.9% in FY03/08F. Besides, the projected negative free cash flow of HK$407.3m in FY03/07F, HK$603.2m in FY03/08F and HK$40.6m in FY03/09F, due to heavy capex, will limit the group's dividend payout and expansion pace. Based on the sector average P/E of 14.2x for FY12/08F, we set our target price at HK$1.34. With a potential downside of 15.2%, we assign a SELL recommendation on the group.

Table 1: Peer group comparison

Company name	Ticker	Year End	Price (HK$)	Market Cap (US$m)	P/E (x) FY07F	P/E (x) FY08F	3-yr EPS CAGR (%)
Panva Gas	1083 HK	Dec	4.32	525	15.6	13.0	26.2
China Gas	384 HK	Mar	1.58	626	21.8	16.8	19.5
Zhengzhou Gas	8099 HK	Dec	0.84	135	8.1	7.2	15.4
Xinao Gas	2688 HK	Dec	8.45	1,041	16.7	14.1	27.0
Average					*17.3*	*14.2*	*24.1*

Source: SBI E2-Capital, Bloomberg

P & L (HK$m)	05A	06A	07F	08F	09F
Year to Mar					
Turnover	**411.4**	**630.5**	**1,402.8**	**2,498.8**	**2,756.7**
% chg	*9.3*	*53.3*	*122.5*	*78.1*	*10.3*
Gross profit	247.4	305.4	566.3	930.3	1,050.0
EBITDA	139.7	179.5	440.8	541.0	659.5
Depre./amort.	(11.1)	(46.9)	(58.5)	(88.4)	(92.3)
EBIT	128.6	132.6	382.3	452.6	567.2
Net int. income/(exp.)	(25.5)	(22.7)	(122.5)	(99.1)	(128.2)
Exceptionals	30.8	72.7	(4.9)	7.5	7.5
Associates	-	(0.1)	0.3	0.3	0.3
Jointly-controlled entit.	-	-	-	-	-
Pre-tax profit	**133.9**	**182.6**	**255.1**	**361.3**	**446.8**
Tax	(1.5)	(2.5)	(6.4)	(10.8)	(22.3)
Minority interests	(35.8)	(23.3)	(32.2)	(45.4)	(55.0)
Net profit	**96.6**	**156.7**	**216.5**	**305.0**	**369.5**
% chg	*20.7*	*62.2*	*38.1*	*40.9*	*21.1*
Dividends	-	(29.2)	(32.5)	(45.8)	(55.4)
Retained earnings	96.6	127.5	184.0	259.3	314.1
EPS (HK$) - Basic	0.052	0.061	0.072	0.094	0.114
EPS (HK$) - F.D.	0.051	0.055	0.067	0.094	0.114
DPS (HK$)	-	0.010	0.011	0.014	0.017
No. sh.s o/s (m) - W.A.	1,845.0	2,548.9	2,986.7	3,234.6	3,234.6
No. sh.s o/s (m) - Y.E.	2,244.8	2,921.6	3,074.2	3,234.6	3,234.6
No. sh.s o/s (m) - F.D.	1,894.3	2,828.4	3,234.6	3,234.6	3,234.6
Margins (%)					
Gross	*60.1*	*48.4*	*40.4*	*37.2*	*38.1*
EBITDA	*34.0*	*28.5*	*31.4*	*21.7*	*23.9*
EBIT	*31.3*	*21.0*	*27.2*	*18.1*	*20.6*
Pre-tax	*32.5*	*29.0*	*18.2*	*14.5*	*16.2*
Net	*23.5*	*24.9*	*15.4*	*12.2*	*13.4*

Balance Sheet (HK$m)	05A	06A	07F	08F	09F
Year to Mar					
Fixed assets	1,320.4	2,151.2	3,063.8	4,163.3	4,872.0
Intangible assets	209.4	275.4	275.4	275.4	275.4
Other LT assets	-	-	-	-	-
Cash	712.0	1,727.1	1,927.7	926.2	1,730.0
Accounts receivable	86.7	347.7	483.2	860.7	949.5
Other receivables	366.7	454.9	478.3	475.7	455.2
Inventories	42.5	108.0	193.7	363.1	395.1
Due from related co.s	-	-	-	-	-
Other current assets	15.3	29.6	1.9	1.9	1.9
Total assets	**2,753.0**	**5,093.9**	**6,424.0**	**7,066.2**	**8,679.1**
Accounts payable	(173.1)	(391.8)	(628.4)	(1,119.4)	(1,234.9)
Other payable	(0.9)	(1.2)	(9.8)	(9.7)	(9.3)
Tax payable	(0.2)	(1.8)	(0.2)	(1.0)	26.7
Due to related co.s	(133.4)	(244.5)	(265.2)	(244.5)	(244.5)
ST debts	(208.8)	(345.7)	(192.3)	(906.8)	(566.9)
Other current liab.	-	(49.4)	-	-	-
LT debts	(1,150.6)	(1,938.8)	(2,724.5)	(1,544.8)	(2,977.9)
Other LT liabilities	-	-	-	-	-
Total liabilities	**(1,667.0)**	**(2,973.1)**	**(3,820.2)**	**(3,826.1)**	**(5,006.9)**
Share capital	22.4	29.2	60.0	91.3	144.7
Reserves	966.2	1,836.2	2,217.9	2,777.6	3,101.3
Shareholders' funds	**988.6**	**1,865.5**	**2,277.9**	**2,868.9**	**3,246.0**
Minority interest	97.4	255.3	325.8	371.2	426.2
Total	**1,086.0**	**2,120.8**	**2,603.7**	**3,240.1**	**3,672.2**
Capital employed	2,445.4	4,405.3	5,520.5	5,691.6	7,217.0
Net (debt)/cash	(647.4)	(557.4)	(989.0)	(1,525.4)	(1,814.8)

Cash Flow (HK$m)	05A	06A	07F	08F	09F
Year to Mar					
EBIT	128.6	132.6	382.3	452.6	567.2
Depre./amort.	11.1	46.9	58.5	88.4	92.3
Net int. paid	25.5	22.7	122.5	99.1	128.2
Tax paid	(1.7)	(0.9)	(8.0)	(10.0)	(50.0)
Dividends received	-	-	-	-	-
Gross cashflow	**163.5**	**201.3**	**555.3**	**630.2**	**737.7**
Chgs. in working cap.	(146.9)	(161.4)	0.6	(53.4)	14.8
Operating cashflow	**16.6**	**39.9**	**555.9**	**576.8**	**752.4**
Capex	(601.2)	(509.2)	(963.2)	(1,180.0)	(793.0)
Free cashflow	**(584.6)**	**(469.3)**	**(407.3)**	**(603.2)**	**(40.6)**
Dividends paid	-	(29.2)	(32.5)	(45.8)	(55.4)
Net distribution to MI	-	-	-	-	-
Investments	-	(17.5)	-	-	-
Disposals	17.1	2.7	-	-	-
New shares	318.3	731.5	187.5	-	-
Others	(195.6)	(128.0)	(179.4)	112.6	(193.4)
Net cashflow	**(444.8)**	**90.1**	**(431.7)**	**(536.3)**	**(289.4)**
Net (debt)/cash - Beg.	(202.6)	(647.4)	(557.4)	(989.0)	(1,525.4)
Net (debt)/cash - End.	(647.4)	(557.4)	(989.0)	(1,525.4)	(1,814.8)

Interim Results (HK$m)	05A	06A	07A
Six months to Sep			
Turnover	**187.7**	**262.5**	**475.1**
% chg	*125.0*	*39.8*	*81.0*
Profit from operations	99.5	69.2	143.9
Interest expenses	(7.5)	(15.9)	(41.6)
Associates	-	(0.1)	0.1
Jointly-controlled entit.	-	-	-
Pre-tax profit	**91.9**	**53.1**	**102.5**
Tax	(0.3)	(0.1)	(1.1)
Minority interests	(25.6)	(9.5)	(11.5)
Net profit	**66.0**	**43.5**	**89.9**
% chg	-	*(34.2)*	*106.9*
EPS (HK$) - Basic	0.039	0.018	0.031
DPS (HK$)	-	-	-

Shareholding Structure	Shares o/s (m)	%
Hai Xia Finance Holdings	340.0	11.1
Liu Ming Hui	248.9	8.1
Sinopec	210.0	6.8
Gail (India)	210.0	6.8
Oman Oil	210.0	6.8
Asian Development Bank	150.0	4.9
Mackenzia Finance Group	231.0	7.5
Public	1475.8	48.0
Total	**3,075.7**	**100.0**

Background

China Gas Holdings is principally engaging in the investment, operation and management of city gas pipeline infrastructure, distribution of natural gas to residential and industrial users, construction and operation of gas stations, and development and application of oil and natural gas related technologies.

Key Ratios	05A	06A	07F	08F	09F
Net gearing (%)	77.1	34.8	41.9	52.2	52.5
Net ROE (%)	13.0	11.0	10.5	11.9	12.1
EBIT ROCE (%)	6.9	3.9	7.7	8.1	8.8
Dividend payout (%)	-	18.7	15.0	15.0	15.0
Effective tax rate (%)	1.1	1.4	2.5	3.0	5.0
Net interest coverage (x)	5.0	5.9	3.1	4.6	4.4
A/R turnover (days)	167.6	125.7	108.1	98.1	119.8
A/P turnover (days)	108.9	163.5	132.7	127.6	155.9
Stock turnover (days)	61.5	84.5	65.8	64.8	81.1

SBI E2-Capital stock ratings:

STRONG BUY : absolute upside of >50% over the next three months
BUY : absolute upside of >10% over the next six months
HOLD : absolute return of -10% to +10% over the next six months
SELL : absolute downside of >10% over the next six months

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