Corporate Snippet

Wed, 25 Jul 2007

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Right direction but demanding valuation — China Utilities

China Gas (384 HK, HK$2.89) — SELL (unchanged)

Target price: HK$2.10 (-27.3%)

More earnings dilution is expected. China Gas reported a 21.3% YoY increase in net profit to HK$225.6m, on the back of 96.1% YoY surge in turnover to HK$1,236.5m for FY03/07A. However, due to the 20.7% increase in number of issued share capital to 3.4b shares, the group's EPS increased 3.3% YoY to HK$0.064 only. Since the group still has US$17.0m worth of CBs outstanding and can be converted into 76.6m shares, more earnings dilution is expected in FY03/08F.

Connection fee remains important. Proportion of revenue generated from the sales of natural gas to the group's total revenue increased to 60.7% in FY03/07A from 45.7% in FY03/06A. Meanwhile, contribution from gas connection to the group's total revenue dropped to 31.3% from 51.6%. Although contribution from gas connection to the group's total EBIT dropped to 51.6% in FY03/07A from 89.5% in FY03/06A, it is still higher than that of the contribution from the sales of gas at 35.6%. Gross profit margin of the sales of gas remained at 15.0%, while the gross profit margin of gas connection dropped 4.0ppt to 78.0%.

Number of projects increased. During the period under review, the group acquired 9 city natural gas concessions in 6 provinces and regions, including Qingdao and Dezhou in Shandong, Dalian, Fushun and Jinzhou in Liaoning, Hohhot in Inner Mongolia Autonomous Region, Yubei District in Chongqing, Wuwei County in Anhui and Qishan County in Shaanxi. As of the end of FY03/07A, the group had secured 57 city piped gas projects in 15 provinces, autonomous regions and directly-administered cities. 37 of them have secured gas supplies. The group plans to increase the total number of operating projects to 45-48 in FY03/08F.

Aim to double its gas supplies. The group's volume of natural gas sold surged 107.6% YoY to 357.7m m^3, thanks to the increase in number of customers and operating projects, as well as per customer consumption. As of the end of FY03/07A, the group's total number of residential customers increased 37.7% YoY to approximately 1.35m. Volume of gas sold to residential households surged 93.7% YoY to 62.0m m^3. Its total number of industrial customers increased 2.7% YoY, to 111 customers, while the volume of gas sold to industrial customers surged 85.2% YoY to 233.4m m^3. Number of the group's commercial customers soared 900.0% to 10, 451 customers. Meanwhile, natural gas sold to commercial customers surged 167.8% to 33.2m m^3. The growth in volume of natural gas sold to residential and industrial customers outpaced the growth in the numbers of customers, implying that per customer consumption was increasing, especially for industrial customers. The group aims to sell 1.0b m^3 of natural gas in FY03/08F, representing an annual growth rate of 179.5%. It has already secured 80.0% of its gas requirement for this fiscal year. Besides, it has secured approximately 160.0m m^3 of natural gas for FY03/09F. The group sourced most of its gas requirement from 3 major natural gas transmission pipelines, including the West to East Pipeline, Sichuan to Shanghai Pipeline and the Xiaxi-Beijing Pipeline.

Tariff is on the upward trend. Due to the heavy consumption, industrial customers remained the most significant customer group to the group, accounting for 65.2% of the group's total volume of natural gas sold in FY03/07A. Meanwhile, volume of natural gas sold to residential households and commercial customers accounted for 17.3% and 9.3% of the group's total volume of natural gas sold, respectively. Tariff for residential households, industrial users and commercial users increased 1.2% YoY, 5.7% YoY and 4.1% YoY, respectively, to RMB1.75/m^3, RMB1.66/m^3 and RMB2.31/m^3.

Aim to double the number of CNG stations. As of the end of FY03/07A, the group had 21 CNG stations. It sold 22.7m m^3 of CNG during the period under review, representing an annual growth rate of 633.2% and accounting for 6.4% of the group's total volume of natural gas sold. However, the group's CNG ASP dropped

5.1% YoY to RMB2.23/m^3, due to the substantial increase in number of refill stations. The group plans to double its number of gas station to 50 by the end of FY03/08F. In FY03/07A, the group signed JV agreement with one of its major shareholder, GAIL to set up a 50:50 JV with authorized share capital of US$50.0m to develop the CNG refill station network in China. GAIL is the largest energy conglomerate in India owned by the government. By leveraging on its partner strength, the group's CNG strategy is expected to execute smoothly.

Upstream expansion. In FY03/07A, the group hold 38.7% interest in a natural gas exploration and production company in Chongqing with 40 natural gas wells and an annual production capacity of 650.0m m^3. Besides, the group invested RMB800.0m to construct a 100.0% owned LNG processing plant with annual production capacity of 450.0m m^3 and a fleet of 150 LNG trailers in Kaixian, Chongqing. The plant is expected to come on stream in 2H FY03/08F. In addition, the group will invest RMB1.2b to construct another LNG processing plant with annual production capacity of 700.0m m^3 and a fleet of 200 LNG trailers in Sichuan province. The plant is expected to commence operation by the end of FY03/09F and it will source the gas from Puguang Gas Field, one of the largest and most abundant natural gas field in China owned by Sinopec with proved gas reserves of 370.0b m^3. The group also formed 50:50 JV with Oman Oil with initial authorized share capital of US$40.0m. The JV will engage in the import of LNG products from Middle East to China. The first cargo is expected to be delivered in September of this year. Though the international natural gas prices are substantially higher than that of the domestic prices, some affluence provinces like Guangdong are willing to pay a premium for imported natural gas, due to tight domestic gas supplies. Going forward, we expect the domestic natural gas price to increase and play a catch-up with international natural gas prices, given the country's growing appetite for natural gas.

Team up with the strongest. In March 2007, the group signed a JV agreement with SK E&S and SK Gas, subsidiaries of SK group in Korea establishing a 50:50 JV to explore opportunities in energy segment, such as exploitation, liquefaction, transportation of natural gas, distribution of city gas as well as import and export of LPG in China and overseas. The new JV will be incorporated in Hong Kong with registered capital of US$20.0m. It is the third JV agreements that the group has signed with major foreign enterprises so far (the group signed JV agreements with its strategic investors GAIL and Oman as well). In our view, forming JV creates a win-win situation to both the group and partners. Through the JVs, the foreign investors can increase their exposure in China natural gas distribution market. For the group, should it invest in a new project by JV, the capital requirement will reduce by half. This will effectively lower its financial burden and the default risk associated with the new projects. Through the JV, the group can leverage on its partner strength and minimize the execution risks associated with the projects.

SELL call reiterated. Trading at 2-year forward PEG of 3.3x, the group's valuation seems stretched compared with the selected HK-listed China natural gas distributors 2-year forward PEG of 2.4x. Thus, we reiterate our Sell recommendation on the group. Based on the sector average PEG of 2.4x and EPS of HK$0.111 for FY03/09F, we revise up our target price to HK$2.10 from HK$1.34, representing a P/E of 19.0x for FY03/09F. However, we are still bullish on the China natural gas distribution segment, given the increasing tariff and the China's strong demand for gas. Among the HK listed China gas distributors, China Oil and Gas (603 HK, HK$1.48, STRONG BUY) remains our top picks, given its high growth potential and undemanding valuation in terms of 2-year PEG.

Table 1: Peer group comparison

Company name	Ticker	Year End	Currency	Price	Market Cap (US$m)	P/E (x) 1-yr forward	P/E (x) 2-yr forward	PEG (x) 2-yr forward
Panva Gas	1083 HK	Dec	HKD	4.5	1,101.8	26.8	21.0	1.0
China Gas	384 HK	Mar	HKD	2.9	1,142.6	28.1	25.9	3.3
Zhengzhou Gas	3928 HK	Dec	HKD	1.9	304.0	20.2	13.8	3.1
Xinao Gas	2688 HK	Dec	HKD	11.1	1,408.5	23.1	19.6	3.3
China Oil and Gas	603 HK	Dec	HKD	1.48	622.3	41.4	27.3	0.7
Average						*27.5*	*22.2*	*2.4*

Source: SBI E2-Capital, Bloomberg

Disclosure of interests: SBI E2-Capital Securities Ltd. acted as the Placing Agent for China Oil And Gas Group in December 2006 and May 2007.