

**Growth driven by acquisitions****China Utilities****China Gas (384 HK, HK\$1.66)****Not Rated**

**Robust growth in interim results.** China Gas (384 HK) reported a 107.0% YoY surge in net profit to HK\$89.9m, or HK\$0.029/share, against an 81.0% YoY rise in revenue to HK\$475.1m for 1H FY03/07A ended September 2006.

**Drop in blended margin.** Blended gross profit margin dropped 15.2 pcp to 33.6% during the period under review. We reckoned that could be attributable to a smaller contribution from pipeline construction segment to total revenue, in proportion. Traditionally, pipeline construction segment commanded the highest gross profit margin among other segments. Proportion of contribution from pipeline construction segment in total turnover declined 17 pcp to 33.0% from 50.0% in the corresponding period last year. However, the contribution from the segment actually increased by 19.1% YoY to HK\$156.6m, in dollar terms. The group's blended gross profit margin had already reported a 12 pcp drop in FY03/05A.

**Gas volume sold.** The group sold 144.4m cubic meters of natural gas during the period under review. 15.4%, 71.5% and 8.1% of the gas was sold to residential users, industrial users and commercial customers, respectively. Pre-tax ASP of residential gas, industrial gas and commercial gas were RMB1.84/cubic meter, RMB1.63/cubic meter and RMB2.11/cubic meter, respectively.

**New projects secured.** During the period under review, the group secured 4 city piped gas projects, 2 long distance pipeline projects and 1 LNG liquefaction project. At mid December 2006, the group had 54 cities and districts piped natural gas projects with exclusive operating rights, 4 long distance gas pipeline projects, 1 natural gas E&P project and 1 LNG liquefaction project.

**New users acquired.** The group acquired 189,828 residential users during the period under review, bringing its total number of residential users to approximately 1.1m by the end of the period. Besides, it completed natural gas connection for 62,417 domestic households, representing an annualized growth rate of 5.5%. Connection fee of residential user increased 1.4% YoY to RMB2,404.0. The group completed natural gas connection for 13 industrial customers and 133 commercial customers, representing an annualized growth rate of 30.0% and 315.6%, respectively.

**Highly geared.** As at the end of 1H FY03/07A, the group's net gearing ratio stood at 30.3%, compared with that of 14.1% reported on March 2006. Its finance costs surged 161.7% YoY to HK\$41.6m. Since all of the group's operating incomes are denominated in RMB, while some of its debts are denominated in foreign currency, it is set to benefit from the appreciation in RMB.

**Valuation.** Going forward, the group's earnings growth will be driven by the acquisition of new projects. Gross margin should have more downside, as proportion of contribution from lucrative pipeline construction segment in total turnover decline, while proportion of contribution from gas sales increase. The group is trading at P/E of 15.6x and 13.7x for FY03/07F and FY03/08F based on consensus estimates, respectively, comparing to the sector average P/E of 16.4x and 13.9x for FY07F and FY08F, respectively.

**Table 1: Peer group comparisons**

| Company name   | Ticker  | Year end | Price<br>(HK\$) | Market cap<br>(US\$m) | P/E (x)<br>FY07F | P/E (x)<br>FY08F |
|----------------|---------|----------|-----------------|-----------------------|------------------|------------------|
| Panva Gas      | 1083 HK | Dec      | 4.97            | 604                   | 17.9             | 15.0             |
| China Gas      | 384 HK  | Mar      | 1.64            | 649                   | 15.6             | 13.7             |
| Zhengzhou Gas  | 8099 HK | Dec      | 0.87            | 140                   | 8.4              | 7.5              |
| Xinao Gas      | 2688 HK | Dec      | 8.6             | 1,060                 | 17.0             | 14.3             |
| <i>Average</i> |         |          |                 |                       | 16.4             | 13.9             |

Source: Bloomberg