

Growth fueled by acquisitions

China Utilities

China Oil And Gas Group (603 HK, HK\$0.425)

Not Rated

Focus on the natural gas businesses in China. Since the disposal of its battery and silicone rubber manufacturing business, China Oil And Gas Group has been focusing on the investment and development of natural gas businesses in China. Through China City Natural Gas Co., Ltd. (CCNGCL), a JV with China Petroleum Pipeline Bureau, the group has obtained approvals for the operation of natural gas distribution businesses in various cities and provinces in China, including Xinling, Tianjin (Binhai District), Liling, Binzhou, Huimin and Qingyun.

Expansion in potential market size. We estimate that collectively, the aforementioned cities have approximately a total population of 5.7m. The group will acquire natural gas business in Nanjing, Jiangsu and Maanshan, Anhui. Following the completion of the acquisitions, the group potential market size will expand by 133.3% to a population of 13.3m.

Return to profitability. The group reported a profit of HK\$44.9m for the eleven months ended June 30, 2006, against a loss of HK\$139.8m reported in the corresponding period last year. However, due to a large amount of construction and installation income was recognized in the corresponding period last year, the group's revenue dropped 24.9% YoY to HK\$150.8m. Operating profit of the group natural gas division rose 7.6% YoY to HK\$34.3m, mainly driven by the increase in sales of natural gas. As the group's network expand, growth in the sales of natural gas will accelerate.

Leverage on partner's strength. The group's JV partner, China Petroleum Oil & Pipeline Bureau is a wholly-owned subsidiary of China National Petroleum Corporation (CNPC), which engaged in the design, installation, development and operation of natural gas pipeline network and ancillary facilities as well as the provision of inspection, maintenance and technological services. Capitalizing on its partner's expertises on the natural gas industry and background, the group's natural gas business should be able to expand on the fast pace. The group has been in discussion with its partner on the development and increase of investments in CCNGCL. Should China Petroleum Oil & Pipeline Bureau increase its investment in CCNGCL, the expansion in the natural gas business will be accelerated.

Fund raising. The group placed of 540.0m new shares in October 2006 and raised HK\$64.0m. The group would issue HK\$162.0m convertible notes to the vendors for the acquisitions of Nanjing gas project and Maanshan project. Upon the exercise of the CBs, 675.0m shares will be issued at HK\$0.24 each. Further, the group entered into a placing agreement to place 360.0m new shares at HK\$0.29 each.

Notes: SBI E2-Capital Securities Ltd. has acted as the Placing Agent for China Oil And Gas Group since December 2006.