Corporate Visit

Wed, 14 Feb 2007

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

China Oil and Gas: Acquisitions fuel growth

Recommendation: Not Rated | **Hong Kong Industrials**

Price	**HK$0.62**	**Yield (7/05A)**	na
12 mth range	HK$0.06-0.91	**ROE (7/05A)**	na
Market cap.	US$200.3m	**Net gearing (7/05A)**	24.8%
No. shares o/s	2,879.7m	**Net debt/sh. (7/05A)**	HK$0.03
Daily t/o, 3 mth	US$4.5m	**BV/sh. (7/05A)**	HK$0.11
Free float %	64.2%	**Consensus EPS**	
Major shareholder	Xu Tie Liang – 27.9%	**- 3/07F**	na
Ticker	0603.HK/ 603 HK	**- 3/08F**	na

Key points:

- Access to new projects and gas sources in China thanks to CPP’s support.
- More acquisitions expected.
- Limited reliance on connection fees for revenue, unlike its Hong Kong-listed peers.
- Xining to supply cheap gas to the group’s other projects in China.
- Profitability boost for the Liling project expected.
- CNG refill stations to drive growth.

Company background. Formerly known as Nippon Asia Investments, China Oil and Gas Group is engaged in the natural gas and other gas and energy related businesses in China. Through China City Natural Gas Co. (CCNGC), its joint venture with China Petroleum Pipeline Bureau (CPP), the company operates four cities natural gas pipeline networks in China, namely, the Xining Project, Liling Project, Qingyun Project and Binzhou Project. It also has two natural gas refill stations in Xining, Qinghai province and plans to build eleven more in Nanjing, Jiangsu province; Binzhou and Qingyun, Shangdong province; and Maanshan, Anhui province.

Partnership with leader. The group’s JV partner, CPP, is a wholly-owned subsidiary of China National Petroleum Corporation (CNPC), which engaged in the design, construction and provision of long distance oil and gas transmission pipelines and peripheral facilities, oil and gas storage facilities, power transmission facilities and telecommunication facilities. It also provides consulting services on pipeline network design and construction. CCP built almost all of China’s major oil and gas transmission pipeline networks, including the world-renowned West to East Pipeline, Zhongxian-Wuhan Pipeline, Ji-Ning Branch of West-East Gas Pipeline, Parallel Shaan-Jing Pipeline and Alashankou-Dushanzi Crude Oil Pipeline. By 2003, it completed 30,000.0km of pipelines, accounting for 85.0% of China’s total. CPP has been expanding to overseas market with projects in Iraq, Kuwait, Tunisia, Sudan, Libyan and Malaysia. It participated in the construction of Pakistan 's White Oil Pipeline Project, the Sino-Kazakh Oil Pipeline and The Zhanazhol-KC13 gas pipeline.

Backed up by strong partner. CPP’s parent, CNPC controls 32,913.0km of oil and transmission pipelines. Besides, CNPC and its listed subsidiary PetroChina (857 HK, HK$9.49, NR) control most of China’s natural gas resources. As of end 2006, PetroChina produced 1,382.4 billion cubic feet (bcf) of natural gas. With its partner’s strong background, the company should gain access to new gas projects in China, as well as natural gas sources, which are scarce these days, in our view.

Acquisitions to fuel growth. Since 2006, the group has acquired operating rights for a few natural gas projects in China, including city pipeline projects in Liling, Hunan; and Binzhou and Qingyun, Shangdong; and for natural gas refill stations in Qingyun and Binzhou, Shangdong; Nanjing, Jiangsu; and Maanshan, Anhui. We expect the company to acquire more operating rights for downstream natural gas distribution projects. Some of China’s gas distributors tend to acquire existing city pipeline projects, as they lack expertise to develop green field projects, which limits their development scope. Supported by CPP, China Oil and Gas has the technological know how to develop green field projects. In fact, its major city pipeline in Xining, Qinghai, was started from scratch and now supplies about 430.0m cubic meters of natural gas per annum.

Immune to regulatory uncertainties. Most of Hong Kong-listed gas distributors rely on their connection fee income, which represented 45.7% of China Gas (384 HK, HK$1.87, SELL) revenue in FY03/06A and 50.2% of Xinao Gas (2866 HK, HK$7.25, NR) revenue in FY12/05A. From 27 December 2006, pipelined gas distributors in Guangdong are no longer allowed to collect gas connection fees from customers, according to the Price Control Administration of Guangdong Province (PCAGP). The move prompted concerns that the fee collection may be abolished nationwide. Since many gas distributors in China collect the connection fee in advance to finance the construction of their pipeline networks and project acquisitions, the move would undermine their financial positions. Unlike its counterparts, the company generates almost all of its revenue from the sale of gas. Among its four city pipeline projects, two have been providing stable and meaningful contributions, according to our estimates. That said, most of its projects are self-sufficient, financially. Besides, with only four projects on hand, the company will be less affected if the connection fee is abolished than distributors with a large number of projects under construction. Compared with other Hong Kong-listed gas distributors who rely on connection fee income, the company's earnings visibility is higher. Nevertheless, we have to admit that without the lucrative connection fee income, the company's blended profit margin would be lower than those of its peers.

Xining - cheap gas source. The group owns 40.0% in the Xining project through its joint-venture CCNGC. Due to its proximity to gas sources and the low gas procurement cost in Qinghai province, Xining's blended profit margin per cubic meter is only RMB0.30, by our estimation. Although the project's gross profit margin per cubic meter is not likely to improve in the near future, given its monopoly status in the region, the project is expected to generate stable income and cash flow. Xining will also play another important role as the major gas source of the group's natural gas refill stations, given the low cost in the region. It is estimated that the group supplies 400.0-430.0m cubic meters of gas per annum in Xining. As the region's sole natural gas distributor, the company can procure more gas from suppliers. Due to seasonality factors in the region (consumption surge in the forth quarter, drop in the second quarter), CCNGC is forced to procure excess gas during summers, because the procurement volume is set on an annual basis. Thus, the company plans to set up a liquefied natural gas (LNG) processing plant to facilitate the transport of this extra gas to different regions.

Boost for Liling project's margin. The JV's 40.0%-owned Liling project is expected to drive growth of the company's city pipelined gas distribution business. Situated in Hunan province, Liling is China's major ceramic manufacturing base. The project's major clients are big industrial users. To encourage them to adopt natural gas as a fuel source, the company has been offering special discounts, which expire by the end of 2007. Thus, we expect the project's gross profit margin per cubic meter to increase to RMB0.40 from RMB0.10. Currently, the third party, who owns the remainder of the JV, owns its processing station, which compresses gas for transmission to the city pipeline network. For this, gas distributors have to pay the processing fee. The JV aims to increase its stake in the project to 60.0% (or 30% for the group) and acquire the processing station, which will boost margins. Given the high gross profit margin and the region's robust demand for natural gas, the company plans to increase the supply of natural gas to 150.0m cubic meters from 45.0m cubic meters per annum.

Refill stations to drive growth. The company has secured permits to operate compressed natural gas (CNG) refill stations in Binzhou and Qingyun, Shangdong; Nanjing, Jiangsu; and Maanshan, Anhui. The Qingyun station has been operating and supplying 50,000.0 cubic meters of CNG per day. Situated right next to the 165 National Highway and close to Dezhou, one of China's major manufacturing bases, it serves mainly high-volume industrial customers and demand is rising fast. Since the group's JV operates a small city pipeline project in Qingyun, the station has a stable source of gas. The Chinese government indicated that selling price of CNG in the region could be increased by 42.6% to as much as RMB3.80 per cubic meter. The gross profit margin per cubic meter of gas sold in the station is estimated at RMB1.30. The group will set up two CNG stations in Binzhou, which like Qingyun's will have a stable source of gas, since the company's JV operates a small-scale pipeline network in the city.

Lucrative business. The company will set up four CNG refill stations in Maanshan, with one processing and supplying CNG to other stations in Maanshan and Nanjing. Maanshan is just 30 minutes away from Nanjing, one of the most affluent cities in the Yangtze River Delta. The gross profit margin per cubic meter of gas sold in the district is estimated at RMB1.68. We expect Nanjing stations to source CNG from the Maanshan mother station, where the ASP is estimated to be about 14.3% lower than in Nanjing, and generate a higher gross profit margin of RMB1.90 per cubic meter of gas sold. The company will also set up four CNG refill stations in Nanjing between 2007 and 2008. Given the cost advantage, an increasing number of public transport vehicles are switching to CNG.

Corporate deals. 1. In February 2006, the current major shareholder, Sino Advance, acquired 321.0m shares from Kingston Finance for HK$38.0m, representing 17.8% of the total issued share capital of the group during that time.

2. In August 2006, the group acquired the operating rights of refill stations in Binzhou and Qingyun, Shangdong, for HK$48.0m in cash and 175.0m shares at HK$0.06 each.

3. In September 2006, the group raised HK$64.2m through a placement of 540.0m new shares at HK$0.12 each.

4. In December 2006, the group acquired the operating rights of refill stations in Maanshan, Anhui for HK$196.4m, which was satisfied by HK$10.4m in cash; the issuance of a two-year term convertible bond worth of HK$90.0m to the vendor, which can be converted into 375.0m shares at HK$0.24 each; and the issuance of 400.0m of new shares to the vendor at HK$0.24 each.

5. In January 2007, the group acquired the operating rights of refill stations in Nanjing, Jiangsu for HK$133.0m, including HK$62.0m in cash and the balance satisfied by the issuance of a two-year term convertible bond worth of HK$66.0m that can be converted into 275.0m shares at HK$0.24 each.

6. In January 2007, the group raised HK$105.6m through a placement of 360.0m new shares at HK$0.29 each.

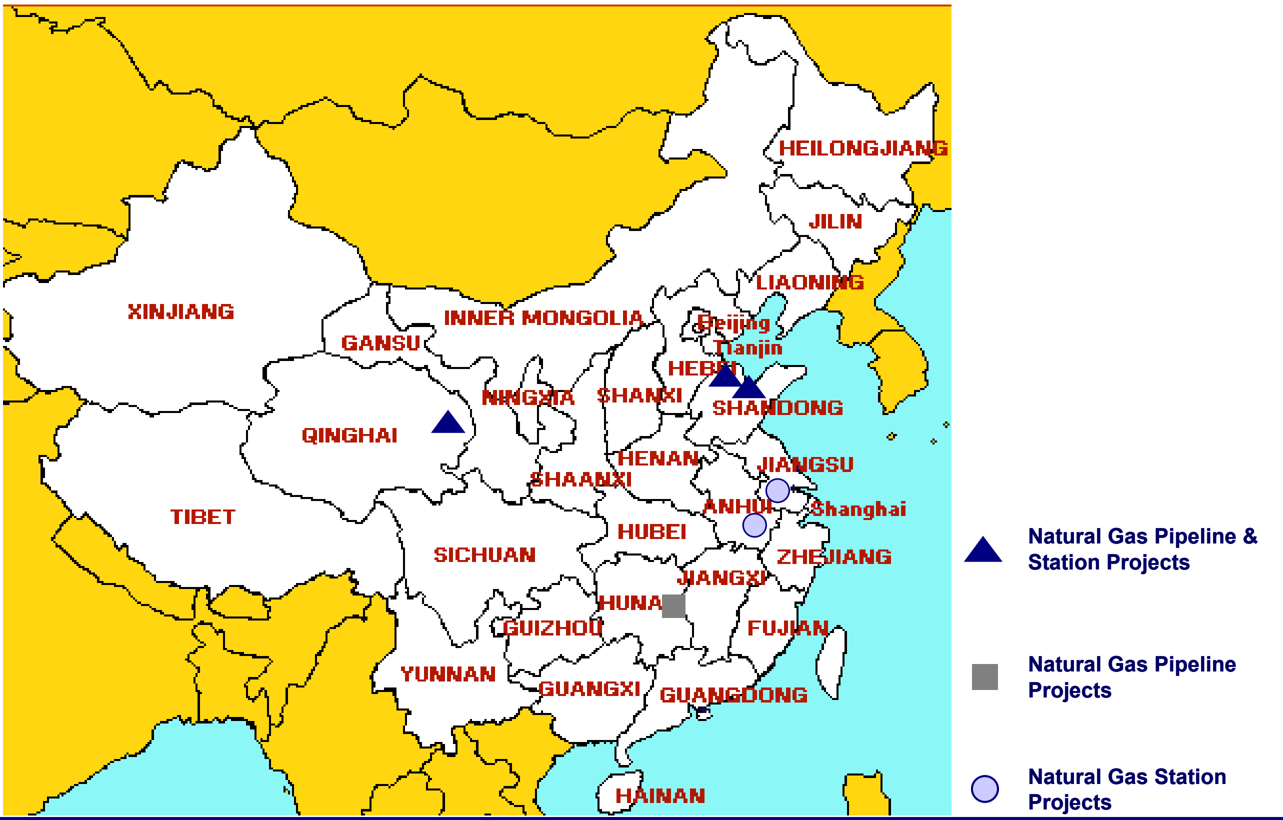
Valuation. The company's total issued share capital will increase from 1,804.7m shares as of June 2006 to 3,929.7m, should all the outstanding CBs exercised. Currently, Hong Kong-listed China gas distributors are trading at an average EV/EBITDA of 9.2x for FY07F and 7.7x for FY08F. We are preparing our earnings forecasts for the group.

Table 1: Peer group valuation

Company name	Ticker	Year	Price	Market Cap	P/E (x)		EV/EBITDA (x)		3-yr EPS CAGR
		End	(HK$)	(US$m)	1-yr forward	2-yr forward	1-yr forward	2-yr forward	(%)
Panva Gas	1083 HK	Dec	3.77	474	15.4	13.0	8.4	7.2	259.4
China Gas	384 HK	Mar	1.87	736	25.8	19.8	11.3	9.2	21.2
Zhengzhou Gas	8099 HK	Dec	0.88	141	8.5	7.6	3.8	3.3	7.1
Xinao Gas	2688 HK	Dec	7.25	904	16.4	13.5	9.4	7.9	29.9
Sino Gas	260 HK	Dec	0.54	103	6.8	3.9	3.7	2.2	na
Average					*18.2*	*14.6*	*9.2*	*7.7*	*70.6*

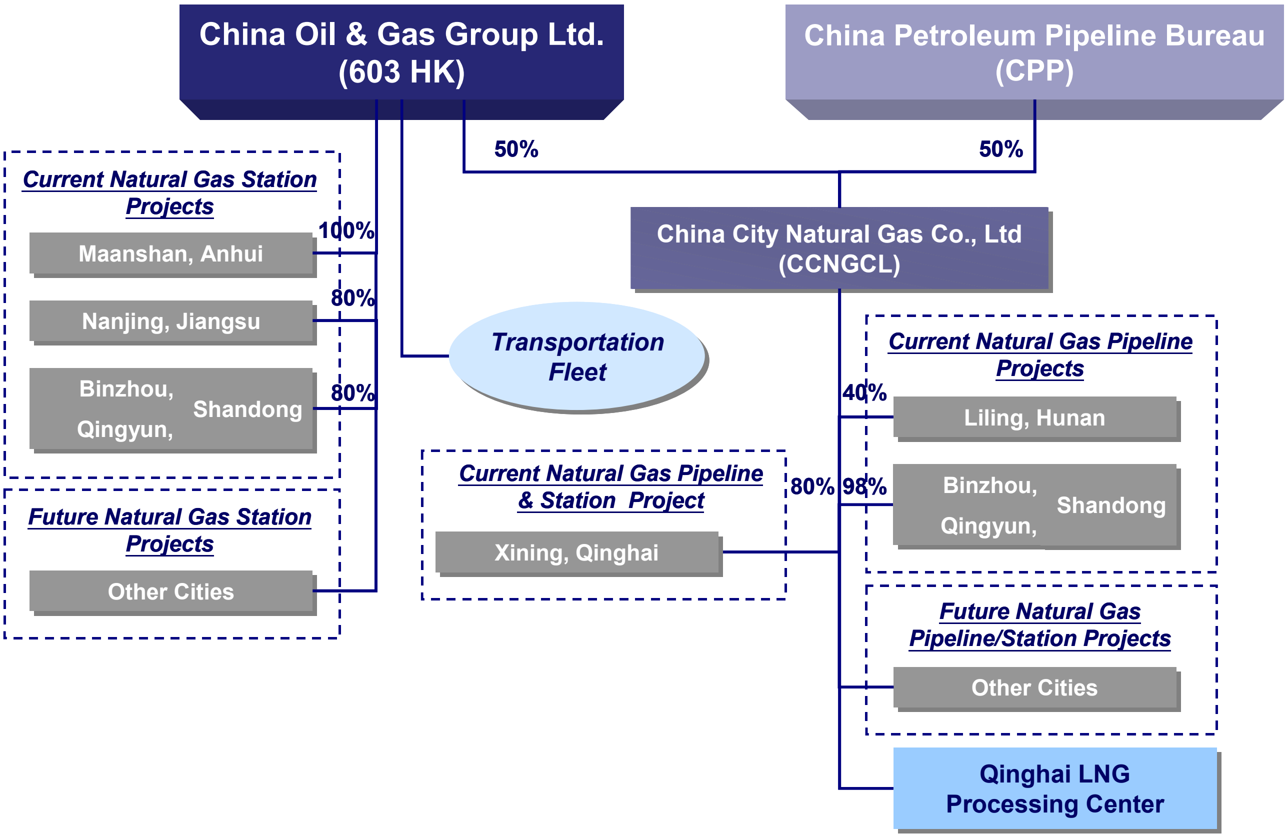
Source: SBI E2-Capital, Bloomberg

Chart 1: Project site overview



Source: Company

Chart 2: Corporate structure



Source: Company

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

P & L (HK$m)	03A	04A	05A
Year to Jul			
Turnover	**278.2**	**153.1**	**205.0**
% chg	-	-	*33.9*
Gross profit	53.5	16.4	62.6
EBITDA	(54.9)	(204.7)	(149.7)
Depre./amort.	(5.2)	(10.0)	(8.1)
EBIT	(60.1)	(214.7)	(157.8)
Net int. income/(exp.)	(1.6)	(3.1)	(2.0)
Exceptionals	(271.8)	5.8	32.8
Associates	-	-	-
Jointly-controlled entit.	0.4	(3.2)	(2.3)
Pre-tax profit	**(333.1)**	**(215.2)**	**(129.3)**
Tax	(1.8)	(0.5)	(3.1)
Minority interests	0.1	(0.2)	(7.3)
Net profit	**(334.8)**	**(215.9)**	**(139.8)**
% chg	-	-	-
Dividends	-	-	-
Retained earnings	(334.8)	(215.9)	(139.8)
EPS (HK$) - Basic	(0.039)	(0.191)	(0.093)
EPS (HK$) - F.D.	(0.039)	(0.191)	(0.093)
DPS (HK$)	-	-	-
No. sh.s o/s (m) - W.A.	8,526.6	1,129.0	1,502.3
No. sh.s o/s (m) - Y.E.	8,685.7	1,129.0	1,502.3
No. sh.s o/s (m) - F.D.	8,526.6	1,734.7	1,734.7
Margins (%)			
Gross	*19.2*	*10.7*	*30.6*
EBITDA	*(19.7)*	*(133.7)*	*(73.0)*
EBIT	*(21.6)*	*(140.2)*	*(77.0)*
Pre-tax	*(119.7)*	*(140.6)*	*(63.1)*
Net	*(120.3)*	*(141.0)*	*(68.2)*

Balance Sheet (HK$m)	03A	04A	05A
Year to Jul			
Fixed assets	95.5	133.7	131.7
Intangible assets	-	-	-
Other LT assets	100.9	123.5	-
Cash	81.3	33.1	35.8
Accounts receivable	2.4	36.7	116.3
Other receivables	14.5	-	-
Inventories	2.1	13.7	11.9
Due from related co.s	16.1	-	-
Other current assets	87.7	16.0	16.7
Total assets	**400.6**	**356.8**	**312.4**
Accounts payable	(2.3)	(59.9)	(42.5)
Other payable	(23.8)	-	-
Tax payable	(0.1)	(1.0)	(3.4)
Due to related co.s	-	-	-
ST debts	-	(24.7)	(9.1)
Other current liab.	-	-	-
LT debts	-	(75.0)	(73.7)
Other LT liabilities	(0.4)	(0.4)	-
Total liabilities	**(26.6)**	**(161.0)**	**(128.7)**
Share capital	217.1	238.0	17.3
Reserves	156.9	(46.4)	153.4
Shareholders' funds	**374.0**	**191.6**	**170.7**
Minority interest	-	4.2	13.0
Total	**374.0**	**195.8**	**183.7**
Capital employed	374.0	295.5	266.5
Net (debt)/cash	81.3	(66.6)	(47.0)

** For the period from 1 Aug 2005 – 30 Jun 2006*

Cash Flow (HK$m)	03A	04A	05A
Year to Jul			
EBIT	(60.1)	(214.7)	(157.8)
Depre./amort.	5.2	10.0	8.1
Net int. paid	1.6	3.1	2.0
Tax paid	(1.5)	0.3	(1.3)
Dividends received	-	-	-
Gross cashflow	**(54.8)**	**(201.3)**	**(148.9)**
Chgs. in working cap.	(35.4)	114.2	(124.5)
Operating cashflow	**(90.2)**	**(87.1)**	**(273.4)**
Capex	(8.1)	(56.9)	(22.6)
Free cashflow	**(98.3)**	**(143.9)**	**(296.0)**
Dividends paid	-	-	-
Net distribution to MI	(0.2)	-	-
Investments	(106.5)	(185.0)	-
Disposals	(10.9)	11.4	12.1
New shares	40.7	32.9	43.0
Others	85.4	136.7	260.4
Net cashflow	**(89.8)**	**(147.9)**	**19.6**
Net (debt)/cash - Beg.	171.1	81.3	(66.6)
Net (debt)/cash - End.	81.3	(66.6)	(47.0)

Interim Results (HK$m)	04A	05A	06A
Six months to Jan			
Turnover	**10.2**	**200.9**	**150.8**
% chg	*(93.4)*	*1,861.6*	*(24.9)*
Profit from operations	(34.6)	(123.5)	57.2
Interest expenses	(0.9)	(3.1)	(1.5)
Associates	-	-	-
Jointly-controlled entit.	0.1	(2.3)	(2.4)
Pre-tax profit	**(35.5)**	**(129.0)**	**53.3**
Tax	-	(3.5)	(1.7)
Minority interests	-	(7.3)	(6.6)
Net profit	**(35.5)**	**(139.8)**	**44.9**
% chg	-	-	-
EPS (HK$) - Basic	(0.004)	(0.093)	0.025
DPS (HK$)	-	-	-

Shareholding Structure		
	Shares o/s (m)	**%**
Xu Tie Liang	1,096.0	27.9
Lo Chung	309.0	7.9
Public	2,524.7	64.2
Total	**3,929.7**	**100.0**

Background

Formerly known as Nippon Asia Investments, China Oil and Gas is principally engaged in investments in the natural gas and other gas and energy related business in China. It has formed a joint venture, China City Natural Gas Co., Ltd ("CCNGCL"), with China Petroleum Oil & Pipeline Bureau, a wholly-owned subsidiary of China National Petroleum Corporation (CNPC). Currently, the group has a number of city pipeline projects and refill stations in China.

Key Ratios	03A	04A	05A
Net gearing (%)	Cash	23.4	24.8
Net ROE (%)	(89.5)	(76.4)	(77.1)
EBIT ROCE (%)	(16.1)	(64.1)	(56.2)
Dividend payout (%)	-	-	-
Effective tax rate (%)	(0.5)	(0.2)	(2.4)
Net interest coverage (x)	na	na	na
A/R turnover (days)	3.1	46.6	136.2
A/P turnover (days)	3.0	74.1	91.2
Stock turnover (days)	3.5	21.2	32.9