

Ups stake in Liling project

China Utilities

China Oil and Gas (603 HK, HK\$1.62)

STRONG BUY

Target price: HK\$2.27 (+40.1%)

Liling project stake lifted to 60.0%. As expected, China City Natural Gas Co (CCNG, 中油中泰), the 51.0%-owned JV of China Oil and Gas with China Petroleum Pipeline Bureau (CPP, 中國石油天然氣管道局), said it would increase its stake in the Liling city natural gas project (Liling project) in July by 20.0% to 60.0% for RMB35.0m, implying that the project is valued at RMB175.0m.

Undemanding valuation. The move will boost the group's effective stake in the project from 20.4% to 30.6%. Based on the project's estimated pre-minority interests earnings of RMB41.6m for FY12/08F and net asset value of RMB42.1m at end-FY12/06A, the acquisition's valuation is estimated at 4.2x P/E and P/BV of 4.1x.

Proven track record. The project's turnover surged more than four-fold to RMB89.0m in FY12/06A and gross net profit rose to RMB12.7m from RMB42,000.0, thanks to its increasing sales to the ceramic sector and a higher pipeline penetration rate. It is estimated that 85.0-90.0% of the project's gas is sold to industrial users.

Focus on industrial users. Liling, an industrial city in Zhuzhou, Hunan province, has a population of about 1.0m. Its production value increased 14.3% YoY to RMB19.0b in 2006, with the ceramic sector accounting for one third of the total. The ceramic industry's output rose at a four-year CAGR of 21.4%, from RMB2.85b in 2001 to RMB6.2b in 2005. The city is one of China's major export-oriented ceramic production bases. Thanks to robust demand from its industrial users, the project's natural gas sales volume per day doubled to 300,000m³ in 1Q 2007 from 150,000m³ in 2006.

Boost to Liling. Special discounts to encourage industrial consumers to use natural gas will expire in phases between 2007 and 2008, improving the project's profitability. The project sources its natural gas from Zhong County – Wuhan pipeline (忠武輸汽管道). As local gas consumption increases, CCNG will be able to secure more gas and develop Liling into a highly integrated system like Xining.

Shandong acquisition plan. CCNG currently operates three city natural gas projects in Shandong province and plans to acquire three industrial user-oriented projects along the Cangzhou-Zibo Pipeline (蒼州淄博管線). Once its capacity reaches critical mass, the company will be able to secure more gas and boost its supply in Shandong in a bid to become the province's major gas supplier and operator. It also plans to acquire two CNG stations.

Attractive. Trading at PEG of 0.80x for FY12/08F, the group's valuation remains attractive against the one-year forward PEG of HK-listed gas distributors. With its strong partner backup, the group's growth potential is tremendous. It also has the simplest revenue model and hence is the most transparent among HK-listed peers. Since our DCF-based target price of HK\$2.27 represents an upside of 40.1%, we reiterate STRONG BUY call.

Table 1: Financial summary

Year to Dec	Net profit RMBm	EPS RMB	EPS Δ %	P/E x	P/B x	EV/EBITDA x	Yield %	ROE %	ROCE %	N. Gearing %
05A	(139.8)	(0.102)	Na	na	16.5	na	-	na	na	24.7
06A	57.3	0.060	Na	27.0	13.1	53.8	-	23.8	17.6	Cash
07F	62.9	0.016	(73.5)	102.0	6.8	27.8	-	9.1	7.8	Cash
08F	160.0	0.036	124.8	45.4	6.7	13.0	-	14.8	12.3	Cash
09F	242.5	0.054	51.6	29.9	6.4	9.1	-	21.8	14.0	29.9

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Table 2: 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	4.0	1,000.4	22.3	18.4	1.9
China Gas	384 HK	Mar	HKD	2.7	1,071.6	39.7	26.5	1.7
Zhengzhou Gas	8099 HK	Dec	HKD	1.8	288.3	18.8	13.0	2.6
Xinao Gas	2688 HK	Dec	HKD	9.9	1,237.6	20.5	17.4	(3.7)

Source: 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.