

# China Oil and Gas



## On the right track

### Key points:

- Interim net profit up 56.3% YoY at HK\$46.5m
- Net cash position of HK\$320.2m
- All convertible notes converted
- Gas sales volume up 64.0% YoY at 477.0m m<sup>3</sup>
- New projects to start contributing soon

**Satisfactory interim results.** Due to the full consolidation of China City Natural Gas (CCNG) into its accounts, China Oil and Gas' profit before minority interests soared 139.5% YoY to about HK\$94.0m in 1H FY12/08A. The group's 51.0%-owned JV with China Pipeline Bureau, CCNG, contributed HK\$585.0m in revenue. Net profit increased 56.3% YoY to about HK\$46.5m, due to strong gas sales and the elimination of minority interests.

**Turnover breakdown.** The group's turnover increased 354.0% YoY to HK\$656.2m in 1H FY12/08A, thanks to the full consolidation of CCNG's numbers into its own account. We estimate that during the period, CCNG's revenue represented 91.5% of the group's total. CCNG's flagship Xinling project alone contributed about 57.1% of the total. Revenue contribution from the Liling project accounted for 23.2%. CCNG's LNG plant in Qinghai provided 2.9% of revenue. The group's CNG stations, including those in Maanshan, Anhui, Nanjing and Shandong collectively contributed 4.3% of the group's total turnover.

**Strong gas sales growth.** The company sold 477.0m m<sup>3</sup> of natural gas, up 64.0% YoY, with 65.0% of sales to the industrial and commercial segment, 6.0% to the government and public utility segment, 9.0% to households and 20.0% to the transport segment. The gas sales volume of the Xinling rose 12.0% YoY in 1H. We reckon that the Liling project contributed most of the increment in gas sales during the period under review.

**Gross margin shrinks.** The group's blended margin narrowed 12.1pcp to 23.8%, mainly due to a substantial drop in pipeline connection fee income upon the completion of the infrastructure of the group's two flagship projects in Xinling and Liling. The gross margin of the pipeline connection business is estimate at about 40.0%. As the company did not provide revenue figures by business lines, we cannot compare the pipeline connection fee income level of 1H FY12/08A. In our view, the drop in connection fee income should be temporary and the level should rise as the company commences the development of Nanchang and Changbei city gas projects in Jiangxi and Chaozhou city gas project in Guangdong.

**CNG stations - lucrative margin.** CNG stations in Nanjing delivered lucrative gross margins of 40.0%. The gross profit margin of the CNG station in Maanshan was 33.0% and mother station 29.0%. The gross margin of the group's flagship Xinling natural gas project is estimated at 15.3%.

**Large debtors and creditors.** Since the group fully consolidated CCNG's balance sheet into its own, its A/R increased 97.0% YoY to HK\$398.6m at end-Jun 2008. Meanwhile, the group's A/P dropped

**BUY**  
(from **STRONG BUY**)

### China Utilities

Tue, 30 Sep 2008

**Andes Cheng**

(852) 2533 3721

andescheng@sbie2capital.com

### Stock data

<b>Price</b>	<b>HK\$0.225</b>
<b>Target price</b>	HK\$0.363(+61.3%)
<b>12 mth range</b>	HK\$0.17-1.22
<b>Market cap.</b>	US\$129.3m
<b>Daily t/o, 3 mth</b>	US\$0.18m
<b>Free float %</b>	68.9%
<b>Ticker</b>	0603.HK/603 HK

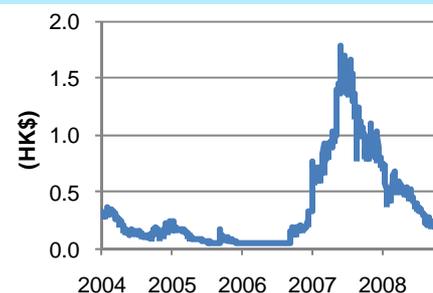
### Financial summary

Year to Dec	06A	07A	08F	09F	10F
Turnover (HK\$m)	369.9	677.4	1616.0	2027.7	2611.3
Net Profit (HK\$m)	57.3	72.6	112.7	147.3	185.2
EPS (HK\$m)	0.031	0.019	0.025	0.033	0.041
EPS Δ %	na	(36.7)	30.8	30.7	25.7
P/E (x)	7.4	11.7	8.9	6.8	5.4
P/B (x)	1.82	0.68	0.54	0.53	0.48
EV/EBITDA (x)	22.0	7.7	3.8	2.8	2.1
Yield (%)	na	na	na	na	na
ROE (%)	18.4	9.3	7.2	7.9	9.3
ROCE (%)	9.2	9.2	10.8	13.1	17.2
N. Gear. (%)	Cash	Cash	Cash	Cash	Cash

### Price Performance

	1 mth	3 mth	12 mth
Relative to HSI (%)	-2.1	-31.2	-65.4
Actual price changes (%)	-19.2	-45.5	-77.7
	08F	09F	10F
Consensus EPS (HK\$)	na	na	na
Previous forecasts (HK\$m)	156.9	236.7	268.4
Previous EPS (HK\$)	0.035	0.053	0.060

### Price Chart



5.7% YoY to HK\$310.4m. Some of the A/R was the receivable of pipeline connection charges on industrial/commercial customers. Such connection fees were calculated as the daily consumption volume multiplied by RMB200.0. As most of the group's industrial/commercial customers prepay by IC card, the group's A/P was considerable.

**Surge in administrative expenses.** The group's administrative expenses surged 250.5% YoY to HK\$49.8m, due to the 318.9% YoY rise in staff costs, HK\$3.6m loss on the disposal of financial assets at fair value through profit or loss accounts and HK\$5.2m fair value losses on the disposal of financial assets at fair value through profit or loss accounts. The group's headcount expanded alongside with its operations. With at least five new projects scheduled between now and 2010, we expect staff related expenses to rise by 2010.

**Financial position.** At end-Jun 2008, the group was in a net cash position of HK\$320.2m. Its gross cash level decreased to about HK\$744.0m from about HK\$836.2m at end-FY12/07A. Meanwhile, its bank borrowings increased to HK\$361.3m from HK\$159.3m at end-FY12/07A due to 1) the consolidation of CCNG's balance sheet, including debt assumed by CCNG; 2) withdrawal of facilities provided by local banks; 3) increase in capital expenditure, in particular fixed investment related to Phase I of the Qinghai LNG plant. In 1H FY12/08A, the group reported an investment cash outflow of HK\$179.1m; 4) RMB appreciation.

**Convertible notes all converted.** The group had convertible notes with principal amount of HK\$145.3m outstanding. In Apr 2008, Chairman Mr. Xu Tie-Liang converted 375.0m shares at HK\$0.24 each from the convertible note issued under the acquisition of Maanshan CNG station operations with the principal of HK\$90.0m. In Aug 2008, a convertible notes' holder converted 275.0m shares at HK\$0.24 each from the convertible note issued under the acquisition of Nanjing CNG station operation with the principal of HK\$66.0m. Following the conversion, the group has no convertible notes outstanding. In Jan 2008, the group purchased 1.44m shares at an average price of HK\$0.4 each at the open market. Taking into account of the conversion and share buyback, we estimate the company's total issued share capital at 4,465.8m, with Chairman Xu holding about 24.5%.

**Future drivers.** 1) New city gas projects in Jiangxi - the group has started to supply gas to Nanchang and Changbei city gas projects in Jiangxi with gas sourced from third parties. The ultimate source of gas for Nanchang is expected to be the West-to-East gas pipeline Phase II, which should commence operation by 2011; 2) Chaozhou city gas project - the group will start to supply gas to Chaozhou by 2009 with gas sourced from third parties. Once the West-to-East gas transmission pipeline Phase II is completed, the Chaozhou gas project will have potential gas sales volume of 1.0b m<sup>3</sup> per annum; 3) The Qinghai LNG processing plant Phase I with designated production capacity of about 50,000.0 m<sup>3</sup> per day was launched at the beginning of 2008. The plant was not fully utilized in 1H FY12/08A and we expect a ramp up in 2H FY12/08F. Since the group has developed its LNG trailer fleet, it can transport the low cost LNG from Qinghai to China's eastern and southern parts where gas prices are substantially higher. The Qinghai LNG processing plant Phase II (designated capacity of more than 80,000.0m<sup>3</sup> per day) is expected to be completed by end-FY12/08F. Once operational, the plant will boost the group's LNG output three-fold to 50.0m m<sup>3</sup>; 4) five CNG stations (one in Shandong, two in Anhui and two in Nanjing) with ample room for gas sales expansion.

**Change in rating and target price.** Based on the current operation performance and business plan, we reformulated our assumptions in the earnings model on the group. We have cut the FY12/08F and FY12/09F earnings forecasts by 28.2% and 37.8%, respectively, to HK\$112.7m and HK\$147.3m. The valuation remains attractive, in our view. HK-listed China gas distributors are trading at an average one-year forward P/E of 14.3x and two-year forward P/E of 11.0x, compared with the group's FY12/08F P/E of 8.9x and FY12/09F P/E of 6.8x. Besides, the group is trading at a 30.6% discount to its ex-CB BVPS of HK\$0.32. The average PE/G of HK-listed gas distributors in China is 0.6x, compared with the group's PE/G of 0.2x. Based on the sector's two-year average P/E of 11.0x, we cut our target price to HK\$0.36, representing an upside potential of 60.0%. We downgrade the group to BUY from STRONG BUY.

**Table 1: Peer group comparison**

Company name	Ticker	Year End	Currency	Price	Market Cap (US\$m)	P/E (x)		PEG (x)
						1-yr forward	2-yr forward	2-yr forward
Panva Gas	1083 HK	Dec	HKD	2.4	594.6	17.1	12.1	0.4
China Gas	384 HK	Mar	HKD	1.2	532.0	13.2	9.1	0.3
Zhengzhou Gas	3928 HK	Dec	HKD	0.7	112.7	5.1	4.4	0.3
Xinao Gas	2688 HK	Dec	HKD	10.0	1,304.8	14.3	11.9	0.8
Average						14.3	11.0	0.6

Source: SBI E2-Capital

P & L (HK\$m)	06A	07A	08F	09F	10F	Cash Flow (HK\$m)	06A	07A	08F	09F	10F
<b>Year to Dec</b>						<b>Year to Dec</b>					
<b>Turnover</b>	<b>369.9</b>	<b>677.4</b>	<b>1,616.0</b>	<b>2,027.7</b>	<b>2,611.3</b>	EBIT	35.3	102.7	225.0	313.1	448.7
% chg		83.1	138.6	25.5	28.8	Depre./amort.	10.5	28.1	36.3	39.8	39.8
Gross profit	79.6	169.7	333.6	429.5	569.3	Net int. paid	(7.8)	2.6	(2.5)	(2.2)	1.2
						Tax paid	0.7	(8.2)	(34.3)	(37.8)	(71.1)
EBITDA	45.8	130.8	261.3	352.9	488.5	Dividends received	(0.1)	(0.0)	-	-	-
Depre./amort.	(10.5)	(28.1)	(36.3)	(39.8)	(39.8)	<b>Gross cashflow</b>	<b>38.6</b>	<b>125.1</b>	<b>224.5</b>	<b>312.8</b>	<b>418.6</b>
EBIT	35.3	102.7	225.0	313.1	448.7	Chgs. in working cap.	62.3	81.0	(147.1)	(53.2)	2.9
Net int. income/(exp.)	(7.8)	2.6	(2.5)	(2.2)	1.2	<b>Operating cashflow</b>	<b>100.9</b>	<b>206.1</b>	<b>77.5</b>	<b>259.6</b>	<b>421.5</b>
Exceptionals	45.9	22.7	-	-	-	Capex	(21.1)	(158.1)	(384.8)	(339.6)	(320.2)
Associates	-	(0.5)	15.6	18.2	17.0	<b>Free cashflow</b>	<b>79.8</b>	<b>48.1</b>	<b>(307.3)</b>	<b>(80.0)</b>	<b>101.3</b>
Jointly-controlled entit.	2.0	2.0	-	-	-	Dividends paid	-	-	-	-	-
<b>Pre-tax profit</b>	<b>75.5</b>	<b>129.4</b>	<b>238.2</b>	<b>329.1</b>	<b>466.9</b>	Net distribution to MI	(4.0)	(9.4)	-	-	-
Tax	(7.3)	(15.6)	(29.0)	(46.7)	(95.5)	Investments	(40.8)	(388.5)	(0.4)	-	-
Minority interests	(10.8)	(41.2)	(96.4)	(135.1)	(186.1)	Disposals	26.0	-	-	-	-
<b>Net profit</b>	<b>57.3</b>	<b>72.6</b>	<b>112.7</b>	<b>147.3</b>	<b>185.2</b>	New shares	64.8	842.4	-	-	-
% chg		26.6	55.2	30.7	25.7	Change in loans	(22.7)	134.6	(91.0)	(13.0)	(42.9)
Dividends	-	-	-	-	-	Others	56.5	(205.8)	260.8	85.5	42.9
Retained earnings	57.3	72.6	112.7	147.3	185.2	<b>Net cashflow</b>	<b>159.6</b>	<b>421.4</b>	<b>(137.9)</b>	<b>(7.6)</b>	<b>101.3</b>
EPS (HK\$) - Basic	0.031	0.021	0.028	0.033	0.041	Net (debt)/cash - Beg.	(47.0)	112.6	534.0	396.1	388.5
EPS (HK\$) - F.D.	0.031	0.019	0.025	0.033	0.041	Net (debt)/cash - End.	112.6	534.0	396.1	388.5	489.8
DPS (HK\$)	-	-	-	-	-	<b>Interim Results (HK\$m)</b>	<b>07A</b>	<b>08F</b>	<b>07A</b>		
No. sh.s o/s (m) - W.A.	1,881.5	3,511.0	4,067.2	4,465.8	4,465.8	<b>Six months to Jun</b>					
No. sh.s o/s (m) - Y.E.	2,519.7	3,817.2	4,465.8	4,465.8	4,465.8	<b>Turnover</b>	<b>144.5</b>	<b>656.1</b>			
No. sh.s o/s (m) - F.D.	1,881.5	4,161.0	4,465.8	4,465.8	4,465.8	% chg	-	354.0			
<b>Margins (%)</b>						Profit from operations	42.5	108.1			
Gross	21.5	25.1	20.6	21.2	21.8	Interest expenses	(0.9)	(6.1)			
EBITDA	12.4	19.3	16.2	17.4	18.7	Associates	2.0	8.5			
EBIT	9.5	15.2	13.9	15.4	17.2	Jointly-controlled entit.	-	-			
Pre-tax	20.4	19.1	14.7	16.2	17.9	<b>Pre-tax profit</b>	<b>43.6</b>	<b>110.5</b>			
Net	15.5	10.7	7.0	7.3	7.1	Tax	(4.4)	(16.6)			
						Minority interests	(7.6)	(44.5)			
<b>Balance Sheet (HK\$m)</b>	<b>06A</b>	<b>07A</b>	<b>08F</b>	<b>09F</b>	<b>10F</b>	<b>Net profit</b>	<b>31.6</b>	<b>49.5</b>			
<b>Year to Dec</b>						% chg	-	56.3			
Fixed assets	112.9	538.5	1,085.0	1,258.5	1,538.4	EPS (HK\$) - Basic	0.010	0.013			
Intangible assets	58.2	560.1	635.9	635.9	635.9	DPS (HK\$)	-	-			
Other LT assets	15.2	1.5	-	-	-	<b>Shareholding Structure</b>					
Cash	165.4	839.2	553.9	460.8	519.2				<b>Shares o/s (m)</b>	<b>%</b>	
Accounts receivable	96.6	202.3	553.4	726.2	895.2	Chairman Xu Tie Liang			1,096	24.5	
Other receivables	-	-	-	-	-	Lo Chung			292.4	6.5	
Inventories	8.2	27.3	55.5	69.5	89.2	Public			3,077.4	68.9	
Due from related co.s	-	-	-	-	-	<b>Total</b>			<b>4,465.8</b>	<b>100.0</b>	
Other current assets	36.1	17.5	0.6	0.6	0.5	<b>Background</b>					
<b>Total assets</b>	<b>492.5</b>	<b>2,186.4</b>	<b>2,884.3</b>	<b>3,151.5</b>	<b>3,678.5</b>	China Oil and Gas Group is engaged in natural gas distribution and other gas and energy-related services in China. Through its 51.0%-owned joint venture with China Petroleum Pipeline Bureau (CPP, 中國石油天然氣管道局), China City Natural Gas Co (CCNG, 中油中泰), it distributes gas in various cities in China. It also operates its own CNG station networks.					
Accounts payable	(95.9)	(316.2)	(540.0)	(673.6)	(865.2)	<b>Key Ratios</b>	<b>06A</b>	<b>07A</b>	<b>08F</b>	<b>09F</b>	<b>10F</b>
Other payable	-	-	-	-	-	Net gearing (%)	Cash	Cash	Cash	Cash	Cash
Tax payable	(8.6)	(17.5)	(14.5)	(23.3)	(47.8)	Net ROE (%)	18.4	9.3	7.2	7.9	9.3
Due to related co.s	-	-	-	-	-	EBIT ROCE (%)	9.2	9.2	10.8	13.1	17.2
ST debts	(14.1)	(225.5)	(16.4)	(42.9)	(13.8)	Dividend payout (%)	-	-	-	-	-
Other current liab.	-	-	-	-	-	Effective tax rate (%)	9.7	12.1	12.2	14.2	20.5
LT debts	(38.7)	(79.7)	(76.8)	(33.9)	(20.1)	Net interest coverage (x)	4.5	na	91.5	140.1	na
Other LT liabilities	(2.6)	(5.4)	-	-	-	A/R turnover (days)	95.3	80.5	85.3	115.2	113.3
<b>Total liabilities</b>	<b>(160.0)</b>	<b>(644.2)</b>	<b>(647.6)</b>	<b>(773.7)</b>	<b>(946.9)</b>	A/P turnover (days)	94.6	111.0	96.7	109.2	107.5
Share capital	25.2	38.2	44.7	44.7	44.7	Stock turnover (days)	10.3	12.7	11.8	14.3	14.2
Reserves	286.2	1,217.0	1,820.1	1,842.2	2,032.0						
<b>Shareholders' funds</b>	<b>311.4</b>	<b>1,255.2</b>	<b>1,864.7</b>	<b>1,886.8</b>	<b>2,076.7</b>						
Minority interest	21.2	287.0	372.0	491.0	654.9						
<b>Total</b>	<b>332.6</b>	<b>1,542.2</b>	<b>2,236.7</b>	<b>2,377.8</b>	<b>2,731.6</b>						
Capital employed	385.4	1,847.4	2,329.8	2,454.6	2,765.5						
Net (debt)/cash	112.6	534.0	460.7	384.0	485.3						

---

SBI E2-Capital is a dedicated small/mid cap investment banking/ stockbrokerage house. Find our research on: [sbie2capital.com](http://sbie2capital.com), [thomsononeanalytics.com](http://thomsononeanalytics.com), [factset.com](http://factset.com) and [multex.com](http://multex.com)

**SBI E2-Capital stock ratings:**

**STRONG BUY** : absolute upside of >50% over the next three months  
**BUY** : absolute upside of >10% over the next six months  
**HOLD** : absolute return of -10% to +10% over the next six months  
**SELL** : absolute downside of >10% over the next six months

Investors should assume that SBI E2-Capital is seeking or will seek investment banking or other related businesses with the companies in this report.

**Analyst certification:** The views expressed in this report accurately reflect the analyst's personal views of the subject securities and that the analyst has not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report.

**Disclaimer:** This research report is not an offer to sell or the solicitation of an offer to buy or subscribe for any securities. The securities referred to in this report may not be eligible for sale in some jurisdictions. The information contained in this report has been compiled by the Research Department of SBI E2-Capital Securities Limited ('SBI E2-Capital') from sources that it believes to be reliable but no representation, warranty or guarantee is made or given by SBI E2-Capital or any other person as to its accuracy or completeness. All opinions and estimates expressed in this report are (unless otherwise indicated) entirely those of SBI E2-Capital as of the date of this report only and are subject to change without notice. Neither SBI E2-Capital nor any other person, accepts any liability whatsoever for any loss howsoever arising from any use of this report or its contents or otherwise arising in connection therewith. Each recipient of this report shall be solely responsible for making its own independent investigation of the business, financial condition and prospects of the companies referred to in this report. SBI E2-Capital and their respective officers, directors and employees, including persons involved in the preparation or issuance of this report, may from time to time (1) have positions in, and buy or sell, the securities of companies referred to in this report (or related investments); (2) have a consulting, investment banking or broking relationship with any company referred to in this report; and (3) to the extent permitted under applicable law, have acted upon or used the information contained or referred to in this report including effecting transactions for their own account in an investment (or related investment) in respect of any company referred to in this report, prior to or immediately following its publication. This report may not have been distributed to all recipients at the same time. This report is issued only for the information of and may only be distributed to professional investors and dealers in securities and must not be copied, published, reproduced or redistributed (in whole or in part) by any recipient for any purpose. This report is distributed in Hong Kong by SBI E2-Capital. Any recipient of this report who requires further information regarding any securities referred to in this report should contact the relevant office of SBI E2-Capital located in such recipient's home jurisdiction.

Copyright © SBI E2-Capital Securities Limited 2008. All rights reserved.

---