Corporate Snippet

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Regulatory uncertainties cloud outlook — China Utilities

Xinao Gas (2688 HK, HK$7.06) — Not Rated

Capacity charge may replace connection fee. Guangdong's Price Bureau announced on 26 December 2006 that gas distributors in the province would no longer be allowed to collect one-off connection fees when they connect new piped-gas users. The National Development and Reform Commission's endorsement of Guangdong's policy prompted concerns that gas distributors' earnings will be negatively affected if the policy is implemented nationwide. The Guangdong government has also proposed to replace the current connection fee with a "capacity charge", calculated according to the distributor's fixed asset investment divided by its supply capacity (in terms of processing station capacity), plus a profit margin. The profit margin and the collection terms are yet to be known. We reckon that the capacity charge will be amortized over a period of time. In effect, instead of paying a one-off connection fee, residential households will pay for connection fractionally on a periodic basis. If adopted, the new policy will represent a change in the calculation and collection of connection fees rather than their total elimination, in our view. Besides, to compensate gas distributors, the Guangdong government will allow them to increase their tariffs.

Threat. Four out of Xinao Gas' 63 projects, Dongguan, Zhaoqing Development Zone, Zhanjiang and Shantou, should be immediately affected by the new policy. Collectively, their connectable population represents 17.1% of Xinao's total connectable population. In 1H 12/06A, connection fee income accounted for 40.2% of the company's turnover. Currently, connection fee income remains vital for most of the HK-listed gas distributors, including Xinao. Since the company capitalizes 50% of its pipeline construction/connection costs, its pipeline construction division has been enjoying a lucrative gross profit margin exceeding 65.0%. In 1H FY12/06A, the company's average connection fee and cost per residential household was RMB2,628.0 and RMB1,700.0, respectively. Its pipeline construction division is the major contributor of the company's EBIT, as well as the major free cash flow generator. Should the new connection fee collection scheme be implemented nationwide, Xinao's earnings and free cash flow would deteriorate, eroding its financial position, or even threatening its existence because of its high gearing. If the connection fee collection is abolished nationwide, it will trigger a consolidation in the gas distribution industry and small distributors may be forced out of the market

Focusing on organic growth. Between FY12/99A and FY12/05A, the number of the company's connected households and installed designed daily capacity for commercial/industrial (C/I) customers increased at a six-year CAGR of 77.9% and 65.1%, respectively. Its piped gas sold to residential households and C/I customers increased at a six-year CAGR of 102.3% and 77.0%, respectively. The strong growth momentum was fuelled by aggressive acquisitions. However, since 2005A, the company has slowed down acquisitions and started focusing on boosting penetration rates at existing projects. The overall penetration rate in its connectable urban population increased from 16.6% in FY12/04A to 19.4% in 1H FY12/06A and is expected to rise to 70.0-80.0%, indicating ample room for expansion. Organic growth in gas sales will remain strong as gas consumption keeps

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 %
04A	250.6	0.296	19.4	23.7	3.2	20.6	0.4	16.4	5.9	49.7
05A	303.1	0.341	15.2	20.6	2.7	14.2	0.7	14.2	4.7	67.7
06F	331.4	0.353	3.6	19.9	2.4	12.9	0.7	12.9	4.4	93.2
07F	430.2	0.442	25.0	15.9	2.2	14.4	0.9	14.4	5.4	89.6
08F	525.0	0.539	22.0	13.0	1.9	15.5	1.2	15.5	6.3	79.5

Note: EPS for FY12/07F and FY12/08F are calculated on fully diluted basis, assuming the outstanding CBs to be converted into shares.

rising with growing user numbers. The increasing penetration rate will improve economies of scale, as fixed unit costs drop. However, since the contribution from the lucrative pipeline connection division to the company's EBIT will drop on slower acquisitions, the company's near-term EPS growth should be mild.

Proximity to gas sources. Xinao's major competitive advantage over its counterparts is its projects' proximity to gas sources. Ten of its projects are either situated in areas covered by major national gas transmission trunk lines, such as West to East Pipeline; or close to major LNG terminals, such as Shenzhen LNG Import Terminal. This lowers the all-in-cost, as transportation expenses make up 17.0% of the cost, by our estimation. It also secures the source of gas. The group now has 63 projects and 73 processing stations, which implies that all of its urban-pipeline projects have their own processing stations, which are essential for effective gas distribution. Processing stations obtain gas from long distance pipelines (such as West to East Pipeline) and after adjusting pressure transmit it to end users. Distributors who have no processing stations have to use others' facilities and pay processing fees or have to operate own storage tanks. Frequently, processing station owners are also distributors and are reluctant to let competitors use their facilities. The operating cost of storage tanks is high, given the need to maintain a fleet of LNG (liquefied natural gas) trucks.

Upstream expansion. In order to secure energy sources and facilitate gas transmission, like its counterparts China Gas (384HK, HK$1.65, SELL), Xinao has been expanding upstream and established a joint venture to invest in the only natural gas source in Jiangsu province. It also invested in an LNG project in Weizhou Island, Guangxi, which came on stream in 2006 becoming the fourth LNG production plant in China. The plant supplies Xinao's projects in Guangdong and Guangxi. The company has also obtained approval from the Ministry of Commerce to import and export natural gas and other energy sources.

Refilling stations - next growth catalyst. In June 2006, the group obtained approval to build 165 CNG stations, of which 15 have been already completed and commenced operations. It also acquired Shanghai Jiuhuan Automobile Liquid Gas Development (Jiuhuan LPG) and Shanghai Jiuhuan Automobile Natural Gas Development (Jiuhuan NG) in May 2006. Through the acquisitions, Xinao got 28 LPG stations and four CNG stations in Shanghai, making it the largest non-petroleum vehicle refilling station operator in Shanghai. As of end-1H FY12/06A, the company had 47 refilling stations and will keep expanding its network by setting up self-owned stations or forming JVs with Sinopec or PetroChina's retail division. We believe the refilling station division has the potential to become another growth catalyst as demand for CNG from taxi and bus line operators increases. The ASP of CNG is about 50.0% lower than that of petroleum products. The gross profit of CNG is estimated at RMB0.37 per cubic meter compared with RMB0.67 per cubic meter for pipelined natural gas for residential households and RMB0.74 per cubic meter for pipelined natural gas for C/I customers.

Preliminary earnings forecast. We expect Xinao's net earning and EPS to increase at a three-year CAGR of 20.1% and 16.5% in FY12/05A and FY12/08F, respectively, against a 38.1% increase in turnover, on the back of 1) higher penetration in its urban connectable population and 2) increase in the number of CNG stations. Major risk factors include: cancellation of connection fees, increase in profit distributable to minority shareholders and higher effective tax rate. As its JV-based projects become more profitable, distribution to JV partners will increase. Also, as the group's projects mature, their tax benefits expire resulting in a higher effective tax rate.

Valuation. Trading at a P/E of 15.9x for FY12/07F and 13.0x for FY12/08F, the valuation is not demanding, compared with the sector average P/E of 16.1x for 2007F and 13.4x for 2008F. Nevertheless, Xinao's 3-year EPS CAGR between FY12/05A and FY12/08F is projected at 16.5%, below the sector's average of 18.6%. Its high gearing makes it vulnerable to changes in the connection fee policy. Regulatory uncertainties will cap the share price performance of China gas distributors in the near term, until the policy is clarified.

Table 2: Peer group comparison

Company name	Ticker	Year End	Price (HK$)	Market Cap (US$m)	P/E (x) 1-yr forward	P/E (x) 2-yr forward	3-yr EPS CAGR (%)
Panva Gas	1083 HK	Dec	4.24	515	17.6	14.9	18.7
China Gas	384 HK	Mar	1.6	633	17.0	14.0	22.9
Zhengzhou Gas	8099 HK	Dec	0.91	147	8.8	7.8	12.9
Xinao Gas	2688 HK	Dec	7.06	884	15.9	13.0	16.5
Average					*16.1*	*13.4*	*18.6*

Source: SBI E2-Capital