

NewOcean Energy

LPG into Guangzhou

to summarize...

- Acquired 17 of 35 auto gas refuelling stations in Guangzhou at attractive price
- Synergy of retail gas business and existing operations
- Guangzhou experience could be promoted to neighbour cities
- New opportunities with regional development
- Business model – essentially independent of LPG price volatility
- Preliminary profit forecast of LPG business at HK\$173.9m for FY12/10F

Acquisition of 17 auto gas refueling stations in Guangzhou. On 21 Oct this year, the company entered into an agreement to acquire 17 auto gas refueling stations in Guangzhou at a total consideration of HK\$583m. At the first stage 5% equity interest is purchased at HK\$3m, and the company has the option to acquire the remaining 95% at HK\$580m in 12 months. While in this 12 months, HK\$580m loan is made to the vendors for HK\$120m interest. Operating auto gas refueling stations in Guangzhou is essentially free of price risk. The major concern is that it needs a steady supply of auto gas for sales.

Operating auto gas refueling stations brings synergy, in our view. Since Mar 2009, auto gas price at Guangzhou refueling stations is officially set at a ~6% margin to import price at port plus transportation cost. With the first class LPG terminal in Zhuhai acquired in 2004, the company obtained all the necessary LPG for sales in the retail market. The original business well supports the refueling stations. On the other hand, prior to the acquisition, the company has relatively limited access to this retail market. In 2009, the company supplied ~100,000 tonnes auto gas to the aforesaid 17 stations, while another 140,000 tonnes is provided by others. This acquisition should likely boost company auto gas sales by more than 100,000 tonnes, in our view.

Attractive price for the 17 refueling stations. There are currently 35 gas refueling stations in Guangzhou, supplying roughly 400,000 tonnes LPG a year. Of the 17 acquired refueling stations, 13 are located at bus terminals, which supplied around 240,000 tonnes to autos. Given HK\$76.5m net profit in 2009, a consideration of HK\$583m represented 7.6x P/E for FY12/09 for this acquisition. However, since the new pricing mechanism was only effective after Mar 2009, we believe a normalized yearly profit could be higher. In Guangzhou, with all taxi and buses using LPG since 2006, we believe profit of the target asset could be HK\$100m+ and possibly HK\$120m in short term. Considering HK\$120m profit for FY12/11F, the valuation of the acquisition is 4.9x P/E for FY12/11F, which is attractive, in our view.

Guangzhou experience could be promoted to neighbour cities. There are currently 8,000 taxis and 18,000 buses using LPG engines in Guangzhou. Since 2006, buses were required to switch to LPG engine. Buses are scheduled at regular time at fixed routes independent of number of passengers, such that they serve as stable demand for LPG. With this demand, it is economical to operate LPG gas refueling stations in Guangzhou, and thus the local government could argued for taxis to switch to LPG. Successfully switching from gasoline and diesel to LPG would effective reduce carbon emission and other emission such as nitrogen oxides and sulfur oxides. While clean energy is mandate of Chinese government, we believe other local governments could adapt Guangzhou model to promote LPG engines. Key to capture this potential move would be the possession of LPG import capability, such as Zhuhai terminal owned by the company.

Ticker	0342 HK
Rating	Not Rated
Price (HK\$)	1.91
Target Price (HK\$)	n.a.
12m Price Range (HK\$)	0.77-1.95
Market cap. (US\$m)	283.0
Daily t/o (US\$m)	2.2
Free float (%)	46.3

Financial summary

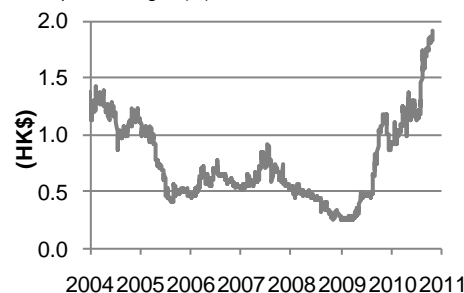
Year to Dec	07A	08A	09A
Turnover (HK\$m)	3,890	6,159	6,483
Net Profit (HK\$m)	50.5	52.9	112.5
EPS (HK\$)	0.095	0.085	0.115
P/E (x)	37.7	36.0	16.9
P/B (x)	3.6	2.6	1.9
EV/EBITDA (x)	15.8	9.3	8.2
Yield (%)	0.7	0.2	0.6
ROE (%)	11.2	8.6	12.8
ROCE (%)	11.2	8.6	12.8
N. Gear. (%)	79.7	75.7	47.6

Source: SBI/Bloomberg

	10F	11F	12F
Consensus EPS (HK\$)	0.160	0.260	-
Previous earnings (HK\$m)	-	-	-
Previous EPS (HK\$)	-	-	-

Price performance

Year to Dec	1m	3m	12m
Relative to HSI (%)	0.6	36.3	59.9
Actual price changes (%)	3.8	49.2	73.6



Source: Bloomberg

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New opportunities with regional development. Local governments are assigned targets of energy conservation as well as emission reduction, which are 2 important items in their appraisals. Therefore, energy conservation and emission reduction are top priorities on government agenda. Besides auto use, we believe clean energy could be largely utilized especially in newly developed area. The emergence of Pearl River Delta could be opportunities to the company. For instance, Hengqin district (橫琴新區) was newly setup in Nov 2009. On the island, University of Macao is building a new campus and expects to complete in 3 years, which should promote city growth in the area and thus the demand for new energy. The company could co-operate with local government to explore new business opportunities with respect to its LPG business.

Business model. The principal business of the company is sales and distribution of LPG and sales of electronics products. The company initially involved the retail sales of bottled LPG to domestic users of China. It subsequently expanded to the import, re-export, wholesale and retail of LPG business after its acquisition of the NewOcean Sea Terminal in Zhuhai in 2004, which has a berth that can handle large LPG ships up to 50,000 tonnes capacity. As a LPG importer, exporter and wholesaler, the NewOcean Sea Terminal has ranked number 1 in China since 2008 in terms of through-put volume.

- Imports from overseas market – the company imported refrigerated propane (C3) and butane (C4) in separate cargoes from gas traders at Zhuhai terminal. The gas traders sourced their supplies from Middle East, West Africa and Australia. For instance, of 798,000 tonnes LPG the company imported in 2009, Geogas supplied the company with 22,000 tonnes per month (effectively 264,000 tonnes a year) by a 50,000 tonne ship. The company handled the imports by a 50,000 tonnes berth in Zhuhai terminal in connection with a 5,000 tonnes berth mainly for re-exports and a storage unit of ~15,000 tonnes for domestic sales. The import price was set on at-port basis at a discount to current monthly average of Argus Far East Index.
- Re-export business – In 2009, 264,000 tonnes LPG was re-exported to HK, Macau, Vietnam, Philippines, etc, which represented ~33% sales of the imported LPG. The price was set at a premium to current monthly average of Argus Far East Index, say US\$5 to 10 premium to the average. That said, re-export business is free of price risk, earning ~US\$10 per tonne, despite possible volatility of LPG price. On an accounting basis, however, profit margin may change significantly because of volatility of the top line (demonolater). Noted that the company has bonded warehouse (保稅倉) free from Chinese duty upon re-export.
- Domestic sales for industrial and autos – Around 534,000 tonnes LPG was supplied to industrial and gas refuelling facilities. It was either distributed by vehicles, through pipes or bottles prepared in a bottling plant. There are 11 pipes connected to the storage unit at Zhuhai terminal which could fully fill 11 vehicles (of 25-tonne capacity each) at the same time within 1 hour. Pricing is usually made at RMB250-350 per tonne premium to Argus Far East Index, depending on the order size as well as method of delivery. Again, this pricing mechanism essentially reduces the impact of LPG price volatility.
- Domestic sales for retails in bottles / bulk selling – domestic retail sales are mainly in form of bottled LPG. In 2009, the company sourced 262,000 tonnes petroleum gas from refineries, which were often treated as residual gas because of presence of impurities. While impurities are well tolerated in residential use, the company bottled petroleum gas and resell bottled LPG to household at a margin, usually calculated at a premium (such as 10%) to Argus Far East Index.

Preliminary profit forecast of LPG segment at HK\$173.9m for FY12/10F – conservative view. On a conservative basis in this preliminary forecast, we assume no growth in volume sales HoH and thus a flat net profit HoH before the effect of acquisition (1H FY12/10 net profit was HK\$77.2m). Our back of pad estimates shows that the acquisition would provide HK\$10m monthly interest and 10,000 tonnes monthly sales with a margin of HK\$350 per tonne for Nov and Dec 2010, which represented extra HK\$20.3m after 25% tax. Therefore, for 2010F, preliminary net profit from LPG segment could be HK\$174.7m. While for 2011, we believe the effect of acquisition will be fully reflected, providing HK\$100m interest, HK\$20m profit from gas station as well as HK\$42m profit from gas sales to stations, representing HK\$122m after tax profit. Based on market cap of HK\$2,208m and net profit of HK\$276m in FY12/11F, conservative estimation of P/E would be 12.6x and 8.0x for FY12/10F and FY12/11F even if the electronic business merely break-even.

Future development. Future development of the company involves expansion in sales volume to domestic market. The key, in our view, is to secure import capability in terms of access to terminals. Opportunities are available such as newly established port facilities (for instance, 東莞市虎門立沙島油氣化工碼頭). In shorter term, the company decides to build 2 more 5,000 tonne berths to further raise through-put volume at an estimated cost of RMB80m. Risk factors, relates to expansion in domestic market, execution ability as well as market competition.

LPG is a clean alternative fuel. LPG is obtained as a by-product when refining crude oil or natural gas and is primarily composed of propane and butane with smaller amounts of propylene and butylenes. LPG has the advantage of: 1) more environmental friendly. When LPG is burnt it produces the almost the cleanest emissions of all oil-based products, with a low carbon dioxide output. LPG emitting 19% less carbon dioxide per kWh than oil, 30% less than coal and more than 50% less than coal-generated electricity distributed via the grid. 2) being stored easily as a liquid as it has property of turning from gas to liquid at atmospheric temperature if moderately compressed. It is 250 times denser as a liquid and hence a lot can be stored in a relatively small container. This characteristic of LPG makes it more flexible in usage than Liquefied Natural Gas (LNG). LPG could also be turned back into gas simply by relieving the pressure. 3) wide varieties of use. LPG could be used for home heating, refrigeration, air-conditioning, automobile, the industrial manufacture of paper, textiles, glass and heavy ceramics and etc.

Valuation. The Hong Kong listed city gas operator is currently trading at average of 22.2x FY12/10F P/E based on market consensus. NOE is currently trading at 11.9x FY12/10F P/E based on market estimate, which is 46.4%% discount to its peers. In our view, the higher valuation of its peers may be for their more diversified business in city gas operation. While NewOcean Energy may be at a discount due to the impression of lower overall profit margin.

Table 1. Hong Kong listed Peers comparison

Company name	Ticker	Last Price (Local)	Mkt cap (US\$m)	His P/E (x)	1-Yr P/E (x)	2-Yr P/E (x)	PB (x)	ROE (%)
ENN ENERGY	2688 HK	24.30	2,605.3	22.9	20.6	17.1	4.0	27.2
CHINA RES GAS	1193 HK	11.80	2,205.9	26.8	27.3	21.5	12.5	23.8
CHINA GAS	384 HK	4.44	1,649.7	17.0	21.6	16.3	3.6	8.4
CHINA OIL AND GAS	603 HK	1.01	510.5	34.0	29.7	20.2	2.2	13.0
NEWOCEAN ENERGY	342 HK	1.91	225.4	14.9	11.9	7.3	2.0	21.9
Average:					22.2	16.5		

Source: Bloomberg

Disclosure of interests: SBI E2-Capital Securities Limited acted as sub-placing agent for NewOcean Energy (stock code: 0342 HK) in December 2009.

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