

Interim results in line

China Utilities

Zhengzhou Gas (8099 HK, HK\$0.94)

BUY (unchanged)

Target price: HK\$1.24 (+32%)

1H FY12/06 results in line with expectations. Zhengzhou Gas (ZZ) reported net profit of RMB58m (up 10% YoY) for 1H FY12/06, which is in line with our earlier expectation of RMB59m. Sales of natural gas reached RMB232.3m (contributed around 65% of 1H06 revenue), up 13% YoY, on the back of increased gas consumption of residential, industrial and commercial users. ZZ totally consumed around 142.6m cubic meter of natural gas in 1H FY12/06 (cf. 131.7m cubic meter in 1H FY12/06). Gas pipeline construction amounted to RMB127m (35% of 1H06 revenue), up 60% YoY, which was attributed to the increasing connection of residential and commercial users. Note that residential users hit almost 600k at the end of 1H FY12/06 (cf. 530k a year earlier), while commercial users reached 1,360 (cf. 1,093 in the previous year). The company did not propose to pay any interim dividend.

Table 1: Interim results

| (RMBm) | 1H06 | 1H05 | YoY (%) | 2H05 | HoH (%) |
|-----------------------------|------|------|---------|------|---------|
| Revenue | 359 | 307 | 16.9 | 313 | 14.8 |
| Gross profit | 120 | 105 | 15.0 | 105 | 14.9 |
| Operating profit | 73 | 69 | 5.2 | 57 | 27.5 |
| Pre-tax profit | 73 | 69 | 5.2 | 57 | 27.5 |
| Net profit | 58 | 52 | 10.1 | 41 | 41.1 |
| <i>Gross margin (%)</i> | 33.5 | 34.1 | | 33.5 | |
| <i>Operating margin (%)</i> | 20.2 | 22.5 | | 18.2 | |
| <i>Net profit (%)</i> | 16.1 | 17.1 | | 13.1 | |

Source: Company data and SBI E2-Capital

Short-term pain, long-term gain. ZZ used to charge an annual repair fee of RMB48 on each user, which accounted for 5.8% revenue in 2005. However, ZZ decided to suspend charging residential users for such fee in 1H FY12/06, given that it was one of the factors being considered by the local authorities in determining the granting of approval of natural gas selling price increase for residential users. ZZ was recently granted an approval to raise its selling prices for commercial and industrial users (from August 15 onwards). Although the suspended fees, together with increased average construction cost for pipeline construction business, have somewhat affected the gross margin for ZZ in 1H FY12/06, we believe meaningful selling price hike for residential users would benefit the company in the long run. Selling price for residential users (i.e. RMB1.6 per cubic meter) has been kept unchanged for the past 4 years, while costs of natural gas have increased sequentially on a yearly basis during the same period. For instance, cost of natural gas from Zhongyuan Oilfield increased to

Table 2: 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 | 65.2 | 0.052 | 23.2 | 18.6 | 3.1 | 11.5 | 0.5 | 18.2 | 18.2 | Cash |
| 05A | 93.4 | 0.075 | 43.2 | 13.0 | 2.6 | 9.4 | 1.7 | 21.6 | 21.6 | Cash |
| 06F | 121.9 | 0.097 | 30.5 | 9.9 | 1.5 | 8.3 | 1.4 | 19.3 | 15.6 | Cash |
| 07F | 173.0 | 0.138 | 42.0 | 7.0 | 1.3 | 7.3 | 2.9 | 19.9 | 13.1 | Cash |
| 08F | 197.3 | 0.158 | 14.0 | 6.1 | 1.2 | 5.1 | 3.3 | 19.8 | 12.0 | Cash |

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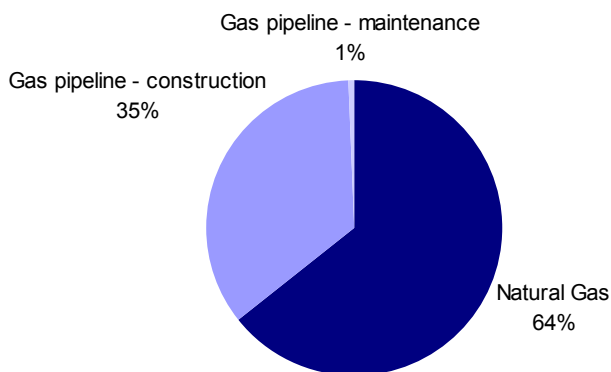
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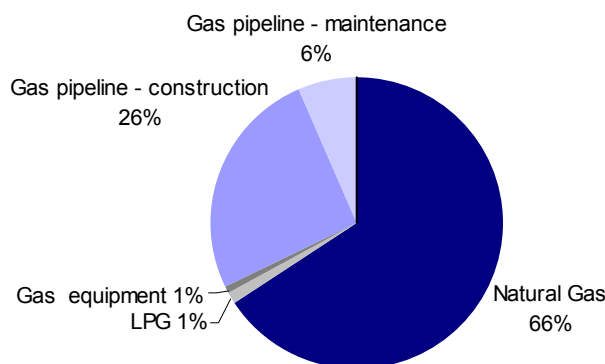
the current level of RMB1.27/ m³ (cf. RMB1.08/m³ in 2005), while cost from West to East pipeline rose to RMB1.24/ m³ now (cf. RMB1.2/ m³ in 2005).

Chart 1: Revenue breakdown in 1H06



Source: Company data and SBI E2-Capital

Chart 2: Revenue breakdown in 1H05



Source: Company data and SBI E2-Capital

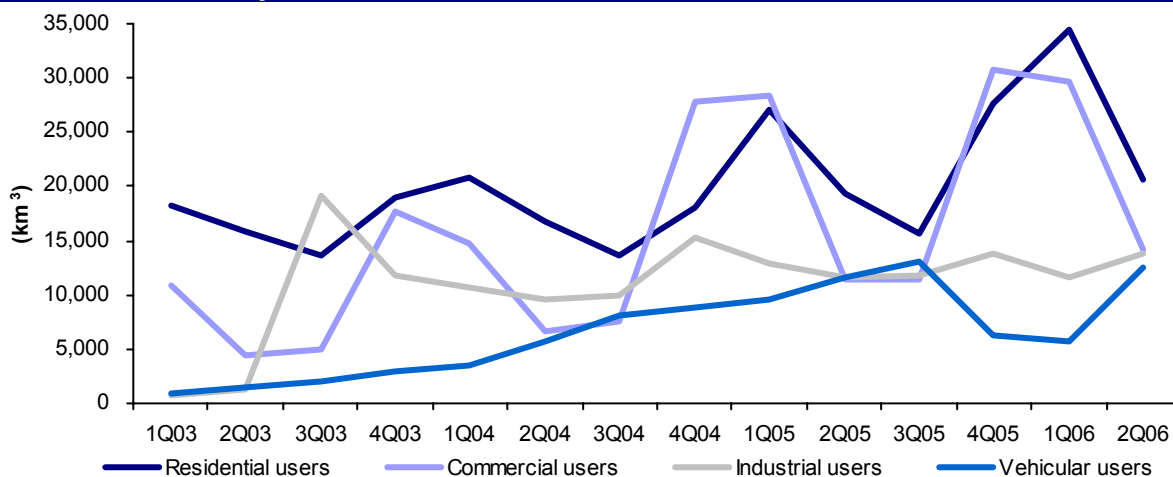
Table 3: Selling prices of natural gas by Zhengzhou Gas

| Selling prices (RMB/m ³) | 2002 | 2003 | 2004 | 2005 | 1H FY12/06 |
|--------------------------------------|------|------|------|------|------------|
| Residential users | 1.6 | 1.6 | 1.6 | 1.6 | 1.6 |
| Commercial users | 2.0 | 2.0 | 2.0 | 2.0 | 2.0 |
| Industrial users | 1.8 | 1.8 | 1.8 | 1.8 | 1.8 |
| Vehicular users | 1.8 | 1.9 | 2.1 | 2.4 | 3.0 |

Source: Company data and SBI E2-Capital

A closer look on a quarterly basis. On a quarterly basis, 1Q is usually the peak season for ZZ, while 2Q is often a soft season and the difference is mainly from the sales of to residential and commercial users. ZZ followed this pattern again in 2Q FY12/06, with earning declining 18% QoQ to RMB26m on a 6% revenue drop to RMB174m. Administrative expenses increased significantly to RMB20.5m (cf. RMB10.9m in 1Q and RMB11.6m in 2Q05) in 2Q FY12/06 due to more provision for staff related remuneration. ZZ recorded tax credit of RMB360k in 2Q FY12/06, as provision made by the company relating to its application to the main board and bonus fund have created deferred tax assets. A deferred tax credit of RMB3.56m was recorded in 1H FY12/06.

Chart 3: Sales volume by various users



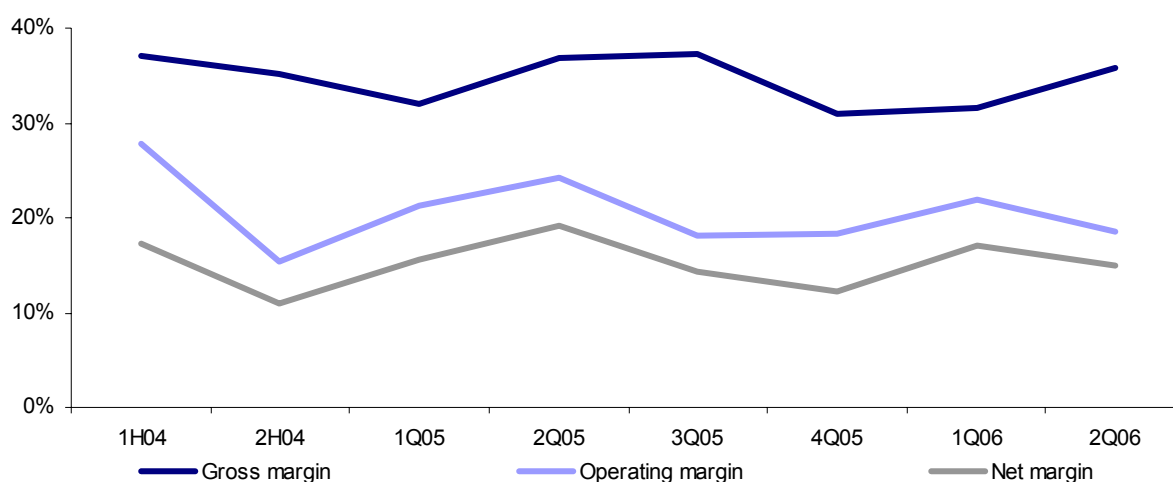
Source: Company data and SBI E2-Capital

2H06 outlooks remain positive. ZZ expects to add 45~50k residential users, 180 commercial users, 4 industrial users and 1,500 vehicle users in 2006. So far, we believe the company is on track to meeting its full-year target, except the growth of industrial users is somewhat slower. Although 3Q will also be a weak season for ZZ based on historical pattern, we believe some recent development of the company has provided some upsides in the mid-term.

Table 4: Accumulated users

| Users | Jun-04 | Dec-04 | Jun-05 | Dec-05 | Mar-06 | Jun-06 | Dec-06F |
|-------------|---------|---------|---------|---------|---------|---------|---------|
| Residential | 474,578 | 508,421 | 531,657 | 568,490 | 580,012 | 597,827 | 618,490 |
| Commercial | 842 | 966 | 1,093 | 1,214 | 1,244 | 1,360 | 1,394 |
| Industrial | 23 | 38 | 45 | 48 | 48 | 48 | 52 |
| Vehicular | 3,083 | 4,079 | 5,013 | 5,522 | 5,767 | 6,440 | 7,022 |
| Total | 478,526 | 513,504 | 537,808 | 575,274 | 587,071 | 605,675 | 626,958 |

Source: Company data and SBI E2-Capital

Chart 4: Margin trends

Source: Company data and SBI E2-Capital

Firstly, ZZ was recently granted an approval to raise its selling prices for commercial and industrial users. Selling price for industrial users will be raised by 17% to RMB2.1/ m³ (cf. RMB1.8/m³ previously). Selling price for commercial users will be adjusted 20% upward to RMB2.4/m³ (cf. RMB2/ m³ previously). Meanwhile, selling price for residential users remains unchanged. Around 37% of its total natural gas was sold to commercial users in 1Q FY12/06 and around 14% to industrial users. All told, benefit from price hike may be limited in 4Q06, as the company may have to source more expensive gas during the peak season. We expect ZZ to see a shortage of 30m m³ towards the peak season if it is unable to secure more gas from PetroChina. As a result, we expect ZZ to see more meaningful margin improvement in 1H FY12/07.

Secondly, we believe market still underestimated the earnings upside potential from ZZ's recent acquisition of its minority stake at a bargained price. Note that ZZ recently announced that it will pay RMB9.9m (will be financed by internal fund) to increase its equity interest from 83.5% to 100% in the Engineering Company. The Labor Union Committee originally owned the 16.5% equity interest. The Engineering Company is mainly engaged in the construction of natural gas pipelines. As of Dec 2005, the total net assets of the Engineering Company amounted to around RMB149.7m and generated a net profit of RMB95.48m in 2005. ZZ believes the acquisition will strengthen its control over the Engineering Company's operation and further enhance shareholders' interest going forward.

Main board listing on the way. The company is still working on the main board listing application (switch from GEM board) and is expected to complete the change by the end of the year. The move should help the company raise its profile in the investment community.

Conclusion. To reflect better selling prices and the acquisition of minority interests, we have revised up our earnings by 1% to RMB122m for FY12/06F and by 13% to RMB173m for FY12/07F. The stock currently trades at 9.9x FY12/06F P/E and 7x FY12/07F P/E. We continue to like the company, given its quality management, steady earnings growth, less dependent on one-time connection fee (less than 35% of revenue contribution), highest dividend payout among its peers (payout of 18% in 2005) and undemanding valuation (7x FY12/07 PE for Zhengzhou Gas cf. 14x for XinAo Gas and 11x China Gas). We have revised up our target price to HK\$1.24 (previously HK\$1.07), which represents 9x FY12/07P/E.