OVERWEIGHT

China gas utilities sector

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A rapid growth sector under the 12th Five-year Plan

In a bid to greatly reduce CO2 emission and reliance on coal and oil as primary energy sources, the central government will continue to promote the usage of natural gas (NG) across the country under the 12th Five-year Plan. Along the NG value-chain, downstream distribution companies will benefit from the significant NG sales volume growth driven by increasing upstream gas sources. We also expect margins to largely remain stable or to contract marginally in 2011 after most of the wellhead NG cost hikes has been passed to downstream users. We reiterate our ***OVERWEIGHT*** *rating on the China NG distribution sector and* ***ENN Energy Holdings (2688 HK)*** *is our top pick.*

- **Long-term NG demand growth in China under the 12th Five-year Plan.** In order to help reduce CO2 emission by 40-45% in 2020 from 2005 levels, the central government targets to boost the NG consumption to 8.3% of total energy consumption in 2015 from current 3.9% and only 2.8% in 2005. Many large-scale national and transnational NG pipeline projects are scheduled for completion in the next five years and downstream piped NG distributors will likely receive abundant NG sources for distribution to end-users. As such, the NG utilities would experience strong volume growth in the coming years.

- **Wellhead NG price hike speeds up upstream NG production and transmission.** In a bid to rationalize the artificially low domestic NG prices and encourage upstream gas producers to produce more, the NDRC raised the onshore wellhead NG price by RMB0.23/m^3, effective from 1Jun2010. As a result, the upstream gas producers would likely accelerate their NG production and this will benefit the downstream city gas operators.

- **Downstream city gas operators' margin will only decline marginally.** We expect the upstream NG cost hike would be mostly passed through to end-users as the central government encourages the foreign investment of city piped gas infrastructure. Most of the commercial and industrial (C&I) NG users would fully bear the latest upstream NG cost increase while residential users would partly bear the cost increase.

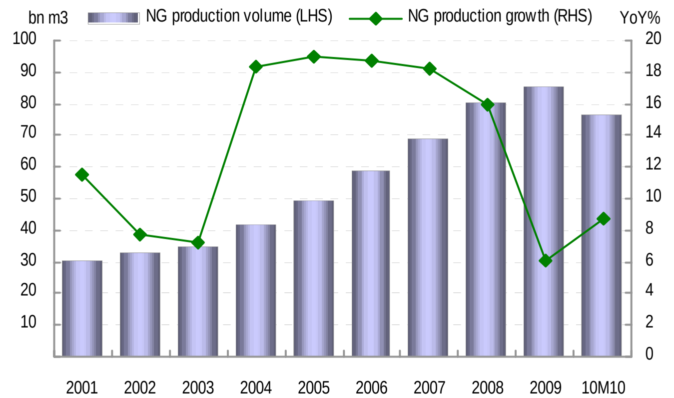
- **ENN Energy is our top pick due to its strong organic growth and attractive valuation.** We expect **ENN (2688 HK)** to register net profit CAGR of 16.5% from 2010 to 2012 on strong organic growth in gas sales. ENN's valuation is also attractive as its FY11F ROE would be the second highest among peers but has lower FY11F PBR relative to **China Resources Gas (1193 HK)**. We reiterate our **BUY** rating on ENN with a 12-M TP of HK$30.3. We maintain Neutral rating on **China Gas Holdings (384 HK)** as the LPG distribution business remains a drag to its overall profitability.

- **Key upside/downside risks to the NG utilities sector.** Near-term upside catalyst for the sector would be based on details of the supportive policies to the sector under the 12th Five-year Plan. Key downside risks include smaller-than-expected upstream cost pass through, weaker-than-expected NG sales volume growth (partly due to NG source shortage) and slowdown in connection fee growth due to property market slump.

Increasing usage of NG under 12th Five-year Plan

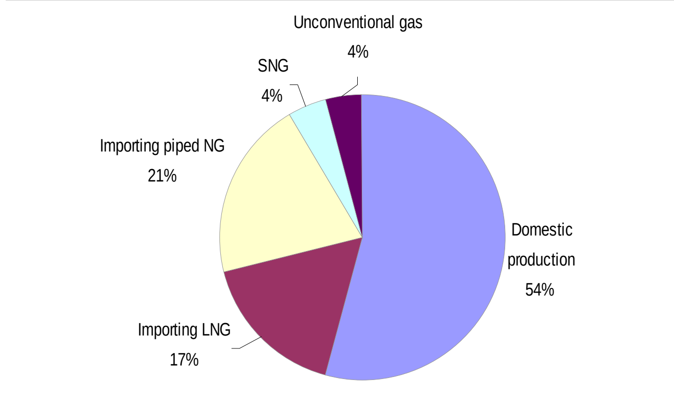
Boost NG consumption weighting – a long-term strategic plan. During the 12th Five-year Plan period, the energy consumption of non-fossil fuels is expected to increase to >11% of total energy consumption in China by 2015. Specifically, NG consumption will hit 260bn m^3 in 2015, representing 8.3% of total energy consumption from 3.9% currently and only 2.8% in 2005. The aggressive 4.4ppt increase of NG weighting in total energy consumption implies the central government has to boost its domestic NG production and importing NG substantially to ease the current NG shortage problem. From the standpoint of downstream city gas operators, the major obstacle to their expansion is the availability of upstream gas source and the central government's strong commitment into the NG supply should gradually remove such growth obstacles in the future.

Figure 1: **China NG production volume grew rapidly**



Source: CEIC

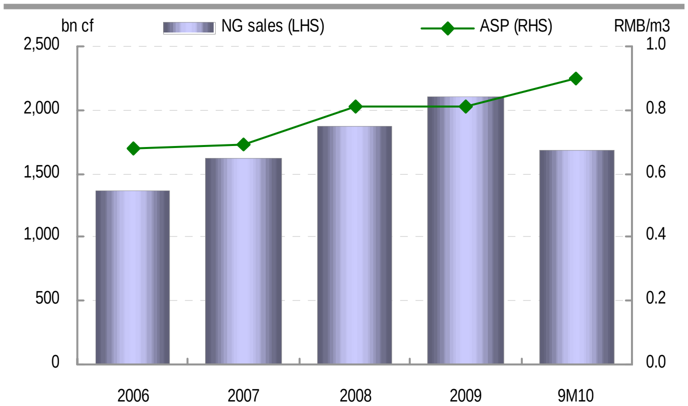
Figure 2: **China's NG source mix**



Source: PetroChina Planning & Engineering Institute

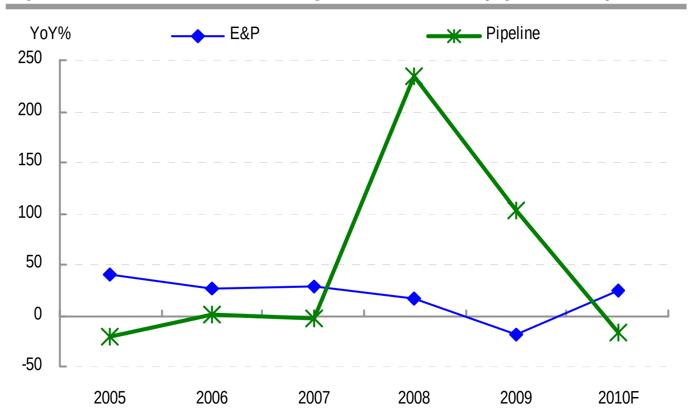
Wellhead NG price hike speeds up upstream NG production and transmission. In a bid to rationalize the artificially low domestic NG prices and encourage upstream gas producers mainly PetroChina (857 HK) to produce more, the NDRC raised the onshore wellhead NG price by RMB0.23/m^3, effective from 1Jun2010. As such, PetroChina's average realized NG price rose 10% yoy to US$3.74/Mcf (RMB0.9/ m^3) for the 9M10 with NG marketable output up 10.5% yoy to 1,684bn cf. PetroChina had said the company would take the NG price hike opportunity to speed up the production of NG and it viewed NG as the company's key growth driver in the future. It plans to boost NG annual output to 120bn m^3 by 2015, compared to 75bn m^3 in 2009. Nevertheless, we expect upstream NG price to remain unchanged in 2011 in the face of rampant inflation pressure.

Figure 3: **PetroChina's NG sales and ASP**



Source: company data

Figure 4: **PetroChina's change in E&P and pipeline capex**



Source: company data

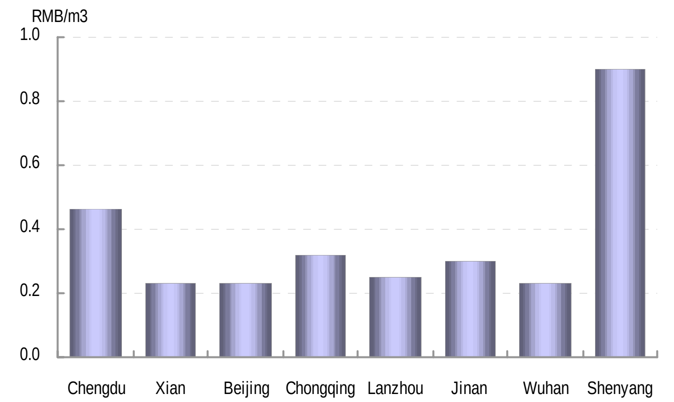
Margin and connection fee to remain robust

Downstream city gas operators' margin will only decline marginally. We are confident of the cost pass-through to NG end-users, in particular to the C&I users. According to ENN Energy and China Gas, almost all of their C&I customers have accepted the NG price hikes and the downstream price increases are even larger than the upstream cost increase of RMB0.23/m^3, and the gas transmission cost rise of RMB0.08/m^3 for certain regions.

For household customers, we expect the upstream NG cost hike to pass through gradually, though it may take some time as the NG price rise for households needs to get through a public hearing. The progress of NG retail price rise for households seems satisfactory. Excluding the extreme case of Shenyang, the average price increase was RMB0.29/ m^3. After the retail price hike in Beijing, whose household NG penetration rate is the highest in the country, we believe other cities would follow.

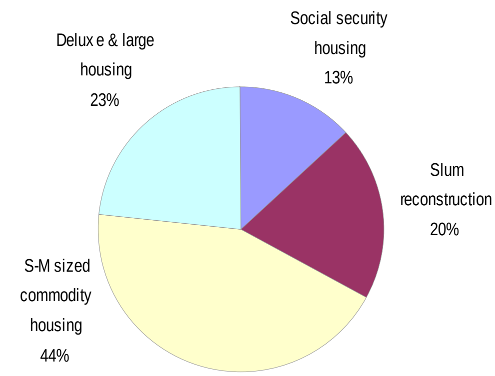
All in all, we expect most of the NG upstream cost hike to pass through to the end-users. Nevertheless, the gross profit margin of pipe NG distributors would experience a mild contraction in 2011 compared to 2010 while their absolute dollar margin would expand slightly given the greater increase of retail NG price in terms of dollar value (i.e. > RMB0.23/m^3). The overall impact should be minimal as the Hong Kong-listed city gas operators such as ENN and China Gas have small proportions of gas sales to residential customers (ENN: 17.6% for 1H10; China Gas: 14.6% for FY10).

Figure 5: **Household retail NG price hikes of selected cities**



Source: Core Pacific - Yamaichi

Figure 6: **Planned land supply for 2010 by land usage**



Source: CEIC

Growth in connection fee bolstered by public housing boom. Despite the slowdown of mainland residential property market, city gas operators' connection fee, whose profit margin is greater than piped gas sales, would maintain double digits growth in 2011, as the central government will strengthen its investment in the low-income public housing. The Ministry of Land and Resources set aside ~33% of land supply for the construction of low-income public housing for 2010. The central government aims to build 10mn units of affordable housing in 2011 with estimated total investment of >RMB1,300bn, up from 5.8mn units in 2010. As such, more low-income public housing will be built next year to cope with the housing needs of low-income family amid the high property prices and thus NG connection to household will remain robust.

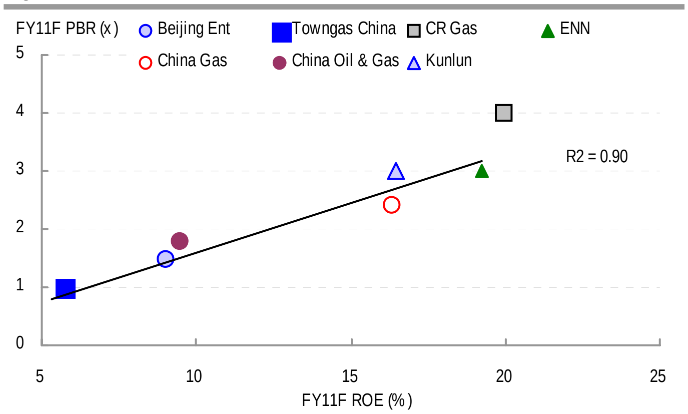
Above-national average growth rate in south-east coastal region. In terms of region, we predict piped NG sales in the south-east coastal region will achieve above-national average growth rate. The south-east coastal region will receive new NG source from the eastern section of the West-East Pipeline II, which will be completed phase by phase within the next two years. Compared to its peers, ENN has the most extensive foothold in this market with a total of 14 city gas projects and 12.2mn connectable population (accounting for 27% of ENN's total population coverage). As of end-09, ENN's penetration rate in Guangdong province was extremely low at 7.6%. Therefore, after the completion of the upstream NG pipeline infrastructure, ENN's city gas projects in Guangdong province, will likely experience above industry growth in next few years.

Bullish on NG utilities sector with ENN (2688 HK) as our top pick

Remain bullish on 2011 and long-term NG distribution sector. Owing to the strong growth in NG sales volume, stable connection fee income growth and only mild contraction in gross profit margin, we remain bullish on the PRC NG utilities sector. Near-term upside catalyst for the sector would be the further details of supportive policy to the sector under the 12th Five-year Plan. Key downside risks include smaller-than-expected upstream cost pass through, weaker-than-expected NG sales volume growth (partly due to NG supply source shortage) and slowdown in connection fee growth due to property market slump.

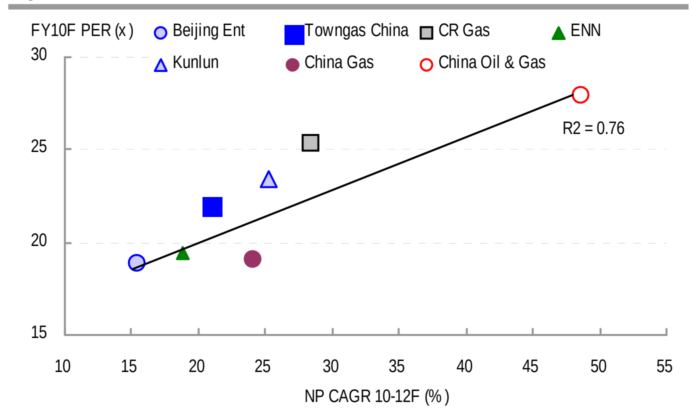
ENN Energy is our top pick due to strong organic growth and attractive valuation. Given the robust organic growth of NG sales, huge potential for its new projects in Guangdong province and stable margin, we expect ENN Energy to register net profit CAGR of 16.5% from 2010 to 2012. ENN's valuation is also attractive as its FY11F ROE would be the second highest among the peers but has lower FY11F PBR relative to **China Resources Gas (1193 HK)**, whose story of parent asset injection should be largely priced in. We reiterate our **BUY** rating on ENN with a 12-M TP of HK$30.3. We maintain **NEUTRAL** rating on China Gas as LPG distribution business remains a drag to its overall profitability.

Figure 7: **FY11F PBR versus FY11F ROE**



Source: Bloomberg and Core Pacific-Yamaichi estimates (CG and ENN)

Figure 8: **FY11F PER versus FY10-12F EPS CAGR**



Source: Bloomberg and Core Pacific-Yamaichi estimates (CG and ENN)

Table 1: **Peer valuation comparisons (as at 30 November 2010)**

Company	Bloomberg code	Closing (HK$)	Mkt cap (HK$mn)	PER (x) 09	PER (x) 10E	PER (x) 11E	PEG 10-12E	PBR (x) 09	PBR (x) 10E	PBR (x) 11E	Yield (%) 10E	Yield (%) 11E
China Gas Holdings*	384 HK	3.97	17,307	25.6	18.5	14.7	0.8	3.2	2.8	2.4	0.8	1.1
Beijing Enterprises	392 HK	48.95	55,674	21.9	19.3	16.4	1.3	1.7	1.6	1.5	1.6	1.8
Towngas China	1083 HK	3.79	9,281	24.0	22.2	18.2	1.0	1.1	1.0	1.0	0.6	0.9
China Resources Gas	1193 HK	11.06	20,252	25.1	25.5	20.2	0.9	11.7	4.8	4.0	0.8	1.0
ENN Energy	2688 HK	22.35	23,471	25.4	18.6	15.4	1.1	4.0	3.5	3.0	1.3	1.6
Kunlun Energy	135 HK	11.30	55,980	25.2	22.6	18.1	0.8	3.7	3.4	3.0	1.1	1.4
China Oil & Gas	603 HK	0.98	4,852	33.0	28.8	18.8	0.6	2.1	2.0	1.8	0.0	0.1
Average				**25.8**	**22.2**	**17.4**	**0.9**	**3.9**	**2.7**	**2.4**	**0.9**	**1.1**

** Fiscal year ended 31Mar*
Source: Bloomberg and Core Pacific-Yamaichi estimates (CG and ENN)