

JPM-pp1

Asia Pacific Equity Research

17 March 2015

# Towngas China Company Limited (1083 HK)

Neutral

Price: HK\$7.24

16 Mar 2015

Price Target: HK\$8.00

PT End Date: 31 Dec 2015

Gas volume growth slowdown in 2H2014, but partly offset by household connection pickup

TCCL announced its FY14 results after market closed today. Stripping away non-core items (mainly FX loss of HK\$141MM vs. FX gain of HK\$160MM in 2013)), core pre-tax profits of ~HK\$1.7B represented a ~+14% growth, a slowdown from 1H2014 levels (core profits up +22% Y/Y). The drag in growth was mainly attributable to 1) slowdown in piped gas sales in 2H2014 (+7% Y/Y vs. +13% in 1H2014) and (2) lower piped gas sales margin after the gas cost hike in Aug 2014 (9.0% / 6.3% in 1H14 / 2H14). But the slowdown was partly offset by pick up in new connected households in 2H2014 (+26% Y/Y) from 1H2014 levels (+11% Y/Y).

- **2H14 gas sales volume slowed down to +7% Y/Y** (~3.2B m3 in absolute terms) from 1H2014 levels (+13% Y/Y), likely due to demand weakness after the Aug gas cost hike. On a full-year basis, gas sales volume increased by +10% Y/Y, slightly behind management guidance of 12-15% Y/Y. Piped gas sales margin also declined to 6.3% in 2H14 (9.0% / 7.1% in 1H2014 / 2H2013), being the lowest half-year period since 2H2010.
- **New household connections picked up in 2H2014 to +26% Y/Y**, or 243,000 households in absolute terms, from 1H2014 levels (+11% Y/Y). On a full-year basis, new household connections increased by +20% Y/Y (373,000 in absolute terms). 2H2014 connection fee margins also maintained at 43.8%, compared to 45.6% / 40.8% in 1H2014 / 2H2013).
- **9 new project acquisitions were secured in 2014**, located in Sichuan, Zhejiang, Jilin, Guizhou, Inner Mongolia, Jiangsu, Yunnan, Shandong and Heilongjiang (Jan-Aug 2014: 8 new projects secured). Total gas consumption to the 9 projects is expected to reach 800MM m3 in five years.
- **Net gearing increased to 39% as of Dec-14**, compared with 29% as of Dec-13 and 35% as of Jun-14.
- **Maintain Neutral:** TCCL's FY14 results confirmed market concerns on the sector (i.e. demand weakness) after the Aug gas cost hike. But we believe the worst might be over as natural gas' competitiveness will be gradually restored with the Government likely to adopt more frequent gas price adjustments (6 months vs. 12 months before) against alternative fuels. In the space, we prefer gas distributors with strong resilient gas demand (BJ Ent), potential M&A upside (China Gas). Investors playing on gas demand recovery after gas cost cuts should focus on **CR Gas** (low base on weak growth).
- **Analyst briefing** will be held on 18 March (Wed) at 5pm HKT in the Soong Room, Level 2, Butterfield's, Dorset House, Taikoo Place, 979 King's Road, Hong Kong.

Table 1: Summary of 2014 results (In HK\$MM unless otherwise specify)

HK\$ millions (per sh. data in HK\$)	1H12	1H13	1H14	Y/Y	2H12	2H13	2H14	Y/Y	2012	2013	2014	Y/Y
<b>Turnover</b>	<b>2,437</b>	<b>2,962</b>	<b>3,674</b>	24	<b>2,746</b>	<b>3,754</b>	<b>4,208</b>	12	<b>5,183</b>	<b>6,716</b>	<b>7,882</b>	17
Piped gas retail sales (continuing)	1,929	2,394	3,030	27	2,043	2,871	3,176	11	3,972	5,265	6,205	18
Gas pipeline construction (continuing)	508	568	645	13	703	883	1,032	17	1,211	1,451	1,677	16
<b>Operating profit ( EBIT)</b>	<b>344</b>	<b>513</b>	<b>454</b>	(12)	<b>560</b>	<b>658</b>	<b>627</b>	(5)	<b>904</b>	<b>1,171</b>	<b>1,080</b>	(8)
Operating margin (continuing ops)	14	17	12	(5)	20	18	15	(3)	17	17	14	(4)
Share of associate / JCEs	251	284	322	13	229	317	303	(4)	480	601	625	4
Finance cost	(76)	(73)	(82)	13	(72)	(91)	(92)	0.8	(148)	(164)	(174)	6
<b>PBT</b>	<b>519</b>	<b>725</b>	<b>693</b>	(4)	<b>716</b>	<b>884</b>	<b>838</b>	(5)	<b>1,236</b>	<b>1,609</b>	<b>1,531</b>	(5)
<b>PAT</b>	<b>400</b>	<b>574</b>	<b>522</b>	(9)	<b>536</b>	<b>652</b>	<b>659</b>	1.1	<b>936</b>	<b>1,226</b>	<b>1,181</b>	(4)
<b>Net profit (reported)</b>	<b>357</b>	<b>533</b>	<b>468</b>	(12)	<b>484</b>	<b>574</b>	<b>586</b>	2.2	<b>841</b>	<b>1,106</b>	<b>1,054</b>	(5)
<b>EPS (reported - HK cents / sh)</b>	<b>14.51</b>	<b>20.51</b>	<b>17.90</b>	(13)	<b>19.66</b>	<b>22</b>	<b>22</b>	1.5	<b>34.17</b>	<b>42</b>	<b>40</b>	(5)
<b>Net Gearing</b>	<b>28</b>	<b>24</b>	<b>35</b>	11	<b>25</b>	<b>29</b>	<b>39</b>	31	<b>25</b>	<b>29</b>	<b>39</b>	31
<b>Operating profit analysis</b>												
Piped gas retail sales (continuing)	148	222	273	23	159	205	199	(3)	308	427	471	10
Gas pipeline construction (continuing)	244	278	294	6	308	360	452	26	552	638	746	17
Others (unallocated)	(48)	13	(113)	(974)	92	93	(24)	(126)	44	106	(137)	(229)
<b>Total</b>	<b>344</b>	<b>513</b>	<b>454</b>	(12)	<b>560</b>	<b>658</b>	<b>627</b>	(5)	<b>904</b>	<b>1,171</b>	<b>1,080</b>	(8)
<b>Segmental margin analysis</b>												
Segmental margin on piped gas sales (%)	7.7	9.3	9.0	(0.3)	7.8	7.1	6.3	(0.9)	7.7	8.1	7.6	(0.5)
Segmental margin on gas pipeline (%)	47.9	48.9	45.6	(3.4)	43.8	40.8	43.8	3.0	45.6	44.0	44.5	0.5

Source: Company data, J.P. Morgan estimates

## Investment Thesis

Towngas China was Hong Kong's first public utility and today is one of the largest energy suppliers in Hong Kong. The core business consists of the production and distribution of gas, sale of gas / gas appliance and after sales services as well.

Our view on the company rests on (1) improving gas sales in 3Q but overall growth relatively low (2) upside potential from boiler replacement (3) low gearing ratio

## Valuation

Our Dec-15 PT of HK\$8.00 is based on DCF assuming a WACC of 10.1% and a 3% terminal growth rate.

## Risks to Rating and Price Target

Main upside risk to our Neutral rating and PT includes higher-than-expected gas sales volume thanks to improved gas supplies. Main downside includes faster-than-expected gas cost hikes

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China city gas

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**Other Companies Discussed in This Report** (all prices in this report as of market close on 17 March 2015)

Beijing Enterprises Holdings Limited (0392.HK/HK\$57.15/Overweight), China Gas Holdings Limited (0384.HK/HK\$12.38/Overweight), China Resources Gas Group Limited (1193.HK/HK\$20.80/Overweight)

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Date	Rating	Share Price (HK\$)	Price Target (HK \$)
04-Dec-06	UW	3.94	4.80
05-Dec-06	OW	3.94	4.80
16-Jan-07	OW	4.34	4.00
17-Jan-07	N	4.34	4.00
12-Sep-07	N	4.79	5.00
25-Mar-08	N	2.97	3.30
27-Aug-09	N	2.60	3.00
06-Nov-09	N	3.32	3.64
16-Mar-11	N	3.89	4.00
16-Aug-11	OW	3.92	5.00
17-Mar-12	OW	5.03	5.95
02-Jul-13	N	7.45	7.00
14-Nov-13	N	7.48	7.50
22-Jul-14	N	8.96	9.40
11-Feb-15	N	7.16	8.00

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