Hong Kong & China Gas

Results a slight miss. Management will still grow New Energy segment

Neutral

0003.HK, 3 HK
Price: HK$17.48
Price Target: HK$20.00

Hong Kong Utilities
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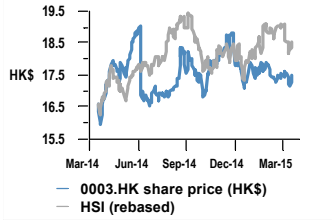
HKCG reiterated its strategy to invest in New Energy projects (using 80% of its capex) and that this will continue to be its highest growth segment. We believe HKCG is becoming less of a utility company and more like an energy play with increased risks to fuel prices. Current low oil price will negatively impact earnings at its Thai oil project this year. We would continue to avoid this name and prefer CKI instead in HK utilities.

- **Operating profit missed:** HKCG reported 2014 operating profit after tax of HK$6.63B, up 8% yoy and ~3% lower than our estimates, due to lower-than-expected income from its New Energy segment. Final DPS of HK$0.23 (flat yoy) and bonus share were in line with our estimates.
- **HK gas sales growth of 1% yoy** was in line with our estimates. Management said they would consider increasing tariffs again after the last tariff hike was implemented in April 2013.
- **China gas volume rose by 14% yoy** to 15.2B m3, in line with our estimates. Management guided for a 2015 target of 17B m3, up 12% yoy, and annual double-digit growth for the next five years. EBITDA margin was 23.3% in 2014 (vs 23.6% in 2013) due to higher feedstock prices.
- **US$35/barrel is breakeven price for Thai project.** New Energy OPAT fell by 2% yoy to HK$510MM, 16% below our estimates. The Thailand oil project, which recorded HK$150MM in profit in 2014, was negatively impacted by lower oil prices, though that was offset by 4x yoy growth in production volume. The breakeven oil price for this project is US$35-40/barrel. Management plans to continue to invest 80% of its capex in New Energy projects, adding that some projects could still get >20% IRR at current oil prices due to lower input cost (methanol).
- **Maintain Neutral** on HKCG due to rich valuation (22x FY15E P/E vs peers' 17x) and increasing risks to fuel prices. We prefer CKI in HK utilities.

Price Performance



	YTD	1m	3m	12m
Abs	-1.6%	-0.1%	2.2%	5.6%
Rel	-3.8%	2.8%	-3.4%	-6.2%

Hong Kong & China Gas (Reuters: 0003.HK, Bloomberg: 3 HK)

HK$ in mn, year-end Dec	FY12A	FY13A	FY14E	FY15E	FY16E
Revenue (HK$ mn)	24,923	28,246	32,122	34,503	37,324
Net Profit (HK$ mn)	7,712	6,854	7,773	8,374	9,087
EPS (HK$)	0.89	0.72	0.77	0.80	0.86
DPS (HK$)	0.35	0.35	0.38	0.40	0.43
Revenue growth (%)	11.1%	13.3%	13.7%	7.4%	8.2%
EPS growth (%)	14.0%	(19.2%)	8.0%	2.9%	8.5%
ROCE	12.7%	10.8%	11.8%	12.8%	13.5%
ROE	16.7%	14.4%	15.3%	15.8%	16.4%
P/E (x)	19.7	24.4	22.6	21.9	20.2
P/BV (x)	3.4	3.4	3.4	3.4	3.2
EV/EBITDA (x)	17.7	18.3	16.5	15.4	14.5
Dividend Yield	2.0%	2.0%	2.2%	2.3%	2.5%

Source: Company data, Bloomberg, J.P. Morgan estimates.

Company Data	
Shares O/S (mn)	10,512
Market Cap (HK$ mn)	183,751
Market Cap ($ mn)	23,671
Price (HK$)	17.48
Date Of Price	18 Mar 15
Free Float(%)	60.0%
3M - Avg daily vol (mn)	8.41
3M - Avg daily val (HK$ mn)	147.45
3M - Avg daily val ($ mn)	19.0
HSI	23,901.49
Exchange Rate	7.76
Price Target End Date	31-Dec-15

See page 8 for analyst certification and important disclosures, including non-US analyst disclosures.

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HK and China Gas

Key catalysts for the stock price:	Upside risks to our view:	Downside risks to our view:
• Higher gas sale volume growth and addition of new city gas projects • Growth in earnings from New Energy segment • Potential share buyback	• Higher-than-expected gas volume sales and margins • Improvement in New Energy earnings • Stronger RMB vs HKD	• Weaker gas sales growth • Higher gas supply cost • Delays in commissioning of New Energy projects

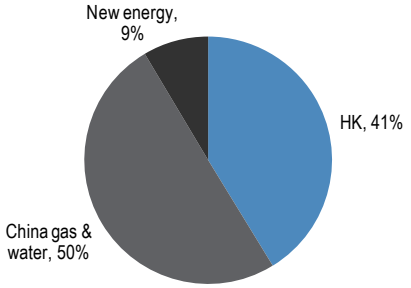
Key financial metrics	FY13	FY14E	FY15E	FY16E
Revenues (HK$MM)	28,246	32,122	34,502	37,323
Revenue growth (%)	13.3%	13.7%	7.4%	8.2%
EBITDA (HK$MM)	11,986	13,387	14,223	15,130
EBITDA margin (%)	42.4%	41.7%	41.2%	40.5%
Tax rate (%)	18%	20%	17%	17%
Net profit (HK$MM)	6,854	7,537	8,376	9,089
EPS (HK$)	0.717	0.751	0.797	0.865
EPS growth (%)	-19.2%	4.7%	6.1%	8.5%
DPS (HK$)	0.35	0.37	0.40	0.43
BVPS (HK$)	5.22	5.17	5.15	5.38
Operating cash flow (HK$MM)	6,992	7,935	9,178	9,862
Free cash flow (HK$MM)	1,906	4,601	5,844	6,529
Interest cover (x)	16	19	22	28
Net margin (%)	24.3%	23.5%	24.3%	24.4%
Sales/assets (X)	0.28	0.30	0.32	0.34
Debt/equity (%)	54.3%	48.1%	38.8%	38.4%
Net debt/equity (%)	43.7%	40.8%	36.3%	31.1%
ROE (%)	14%	15%	16%	16%
Key model assumptions	**FY13**	**FY14E**	**FY15E**	**FY16E**
HK gas volume growth (%)	0.7	0.7	0.7	0.7
China gas volume growth (%)	12.6	14.0	13.0	12.0
Interest rate (%)	2.9	2.9	2.9	2.9

Source: Company data and J.P. Morgan estimates.

Valuation and price target basis

Our Dec-15 PT for HKCG is determined based on a sum-of-the-parts valuation, using DCF to value the HK, China and New Energy segments and NAV to value the Property segment. Our PT implies FY15E PER of 25x and yield of 2.0%.

HKCG 2014E operating earnings breakdown



Source: Bloomberg, Company data and J.P. Morgan estimates.

Sensitivity analysis	EBITDA	
Sensitivity to	FY14E	FY15E
2% chg in HK gas sales	1.0%	0.9%
2% chg in China gas sales	1.0%	1.1%
2% chg in RMB/HK$	1.1%	1.2%

Source: J.P. Morgan estimates.

JPMe vs. consensus, change in estimates		
EPS (LC)	FY14E	FY15E
JPMe old	0.75	0.80
JPMe new	NA	NA
% chg	*NA*	*NA*
Consensus	0.68	0.74

Source: Bloomberg, J.P. Morgan estimates.

Comparative metrics

	Ticker	Mkt Cap	P/E (x)		Net gearing (%)		Yield (%)		P/B (x)		ROE (%)	
		$Mn	FY14E	FY15E	FY14E	FY15E	FY14E	FY15E	FY14E	FY15E	FY14E	FY15E
CKI	1038 HK	20,868	15.6	14.9	16	16	2.9	3.1	1.8	1.7	12.6	11.8
PAH	6 HK	20,481	19.8	18.7	(41)	(42)	3.6	3.7	1.3	1.3	8.4	6.9
HKEI	2638 HK	5,891	15.1	14.9	94	94	7.0	7.6	1.0	1.0	10.1	6.4
CLP	2 HK	21,280	16.2	15.2	67	62	4.0	4.1	1.8	1.8	11.6	11.8
HKCG	3 HK	23,558	22.6	21.9	41	36	2.2	2.3	3.4	3.4	14.3	14.8
Average		**18,415**	**17.8**	**17.1**	**35**	**33**	**3.9**	**4.1**	**1.8**	**1.8**	**11.4**	**10.3**

Source: Bloomberg, J.P. Morgan estimates. Prices are as of March 18, 2017.

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Results review

Table 1: HKCG P&L

HK$MM

HKCG's P&L	2013	2014	yoy
Turnover			
Gas sales before fuel cost adj	19,446	21,841	12%
Fuel cost adj	1,962	1,727	-12%
Gas sales after fuel cost adj	**21,408**	**23,568**	10%
Equipment sales and maintenance services	1,716	2,041	19%
Water sales	979	1,096	12%
Coal and oil sales	747	1,220	63%
Rental income	42	52	24%
Others	3,355	3,639	8%
	28,246	**31,615**	12%
Direct costs			
Stores and materials used	(14,722)	(16,298)	11%
Manpower costs	(2,282)	(2,706)	19%
Depreciation and amortisation	(1,649)	(1,952)	18%
Others	(2,894)	(3,398)	17%
	(21,546)	**(24,354)**	13%
Other income			
Net investment gain	938	444	-53%
Other income/ (expenses)	32	(32)	-200%
Others	(4)	(0)	-95%
	965	**412**	-57%
Finance costs	(926)	(1,013)	9%
Share of results of associates	1,389	1,725	24%
Share of profits of JCE	1,283	1,490	16%
Profit before taxation	**9,411**	**9,875**	5%
Taxation	(1,655)	(1,771)	7%
Profit after taxation	**7,756**	**8,103**	4%
Minority interest	(902)	(892)	-1%
Holders of perpetual capital securities	-	(102)	NA
Profit attributable to equity shareholders	**6,854**	**7,109**	4%
EPS (HK cents)	65.20	67.60	4%
DPS (HK cents)	35.00	35.00	0%
Payout ratio on recurring income	53%	58%	4.7 ppts
Finance cost	3.0%	3.3%	0.3 ppts
Effective tax rate	17.6%	17.9%	0.4 ppts

Source: Company reports.

Table 2: HKCG operations details

Operations			
Volume gas sold:	**2013**	**2014**	**yoy**
In HK (mn MJ)	28,556	28,835	1%
In China (bn m3)	13.4	15.2	13%
Number of Customers in HK (mn)	1.8	1.8	1%
Number of City-gas Customers in China (mn)	17.3	19.0	10%

Source: Company reports.

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Table 3: HKCG segment breakdown

HK$MM

Segment	2013	2014	yoy
HK (gas, water and related biz)			
Revenue	9,620	9,600	0%
Adjusted EBITDA	4,208	4,283	2%
EBITDA Margin	44%	45%	0.9 ppts
Operating profit after tax	2,670	2,690	1%
China (gas, water and related biz)			
Revenue	15,739	18,374	17%
Adjusted EBITDA	3,717	4,288	15%
EBITDA Margin	24%	23%	-0.3 ppts
Operating profit after tax	2,960	3,430	16%
New energy			
Revenue	2,423	3,112	28%
Adjusted EBITDA	856	1,061	24%
EBITDA Margin	35%	34%	-1.2 ppts
Operating profit after tax	520	510	-2%

Source: Company reports.

Table 4: HKCG balance sheet

HK$MM

HKCG's balance sheet			
Non-current assets	**2013**	**2014**	**yoy**
Fixed Assets	47,648	52,037	9%
Intangible assets	5,253	5,859	12%
Interest in associates and JCE	25,954	26,606	3%
Empolyee retirement benefit assets	66	-	-100%
Others	5,784	5,268	-9%
	84,707	89,769	6%
Current assets			
Inventories	2,383	2,283	-4%
Trade & other receivables	6,568	6,976	6%
Others	3,889	2,777	-29%
Bank deposits and cash	8,849	12,606	42%
	21,689	24,642	14%
Current liabilities			
Trade and other payables	(11,272)	(11,943)	6%
Current portion of bank loans	(6,222)	(7,050)	13%
Current taxation	(896)	(806)	-10%
Others	(871)	(892)	2%
	(19,262)	(20,690)	7%
Non-current liabilities			
Interest-bearing borrowing	(24,401)	(24,484)	0%
Customers' deposits	(1,233)	(1,256)	2%
Deferred taxation	(4,711)	(5,169)	10%
Others	(417)	(588)	41%
	(30,763)	(31,498)	2%
Equity			
Share Capital	2,390	5,475	129%
Reserve	47,478	47,154	-1%
Shareholders' funds	49,868	52,628	6%
Minority interests	6,503	7,242	11%
Perpetual capital securities	-	2,354	NA
Total	56,371	62,224	10%
Net gearing	44%	36%	-7.7 ppts

Source: Company reports.

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Investment Thesis, Valuation and Risks

Hong Kong & China Gas *(Neutral; Price Target: HK$20.00)*

Investment Thesis

Hong Kong and China Gas is the largest downstream gas distributor in Hong Kong and China, with its monopoly position in HK and >100 city-gas projects in China. The company is also involved in upstream energy and midstream projects in China. It also owns a 15.8% stake in the IFC complex in HK.

Valuation

Our Dec-15 PT for HKCG is determined based on a sum-of-the-parts valuation, using DCF to value the HK, China and New Energy segments and NAV to value the Property segment. Our PT implies an FY15E P/E of 25x and a yield of 2.0%.

HKCG: sum-of-the-parts valuation

Segment	Discount rate	Terminal growth rate/ exit multiple	Valuation methodology	Valuation (HK$mn)	NAV per share (HK$)	% of total
HK gas segment	5.5%	3.0%	DCF	118,993	11.3	50%
China gas & water	8.0%	9xEBITDA	DCF	82,759	7.9	35%
New energy segment	8.4%	9xEBITDA	DCF	16,261	1.5	7%
Property	NA	NA	NAV	19,848	1.9	8%
Net debt				(19,510)	(1.9)	
Minority interest				(8,628)	(0.8)	
Total					**20.0**	**100%**

Source: J.P. Morgan estimates.

Risks to Rating and Price Target

Upside risks:

1) strong gas demand in HK and China would result in higher revenue,

2) potential M&A of gas projects and city gas companies may result in higher earnings,

3) stronger-than-expected earnings from upstream projects,

4) share buybacks would result in increase in share price.

Downside risks:

1) inability to pass on fuel cost in China and HK would result in lower earnings

2) change in HK regulatory regime may result in lower returns

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Hong Kong & China Gas: Summary of Financials

Income Statement

HK$ in millions, year end Dec	FY12	FY13	FY14E	FY15E	FY16E
Revenues	24,923	28,246	32,122	34,503	37,324
% change Y/Y	11.1%	13.3%	13.7%	7.4%	8.2%
EBITDA	12,215	11,986	13,387	14,223	15,130
% change Y/Y	20.6%	(1.9%)	11.7%	6.2%	6.4%
EBIT	10,749	10,337	11,536	12,314	13,166
% change Y/Y	21.9%	(3.8%)	11.6%	6.7%	6.9%
EBIT Margin	43.1%	36.6%	35.9%	35.7%	35.3%
Net Interest	(697)	(748)	(716)	(657)	(534)
Associates	3,655	2,672	2,985	3,301	3,605
Other Income	-	-	-	-	-
Earnings before tax	9,886	9,411	10,643	11,480	12,454
% change Y/Y	22.5%	(4.8%)	13.1%	7.9%	8.5%
Tax	(1,485)	(1,655)	(1,847)	(2,003)	(2,171)
as % of EBT	15.0%	17.6%	17.4%	17.5%	17.4%
Exceptional items	-	-	-	-	-
Net income (reported)	7,712	6,854	7,773	8,374	9,087
% change Y/Y	25.4%	(11.1%)	13.4%	7.7%	8.5%
Shares outstanding	8,691	9,560	10,512	10,512	10,512
EPS (reported)	0.89	0.72	0.77	0.80	0.86
% change Y/Y	14.0%	(19.2%)	8.0%	2.9%	8.5%

Cash flow statement

HK$ in millions, year end Dec	FY12	FY13	FY14E	FY15E	FY16E
Pre-tax profit	9,886	9,411	10,643	11,480	12,454
Depr. & amortization	1,465	1,649	1,851	1,909	1,964
Change in working capital	519	(51)	(424)	498	594
Taxes	(1,323)	(1,301)	(1,743)	(1,918)	(2,080)
Others	(3,030)	(1,460)	(1,142)	(1,458)	(1,784)
Cash flow from operations	6,666	6,992	8,058	9,323	9,862
Capex	(5,816)	(5,086)	(3,333)	(3,333)	(3,333)
Disposal/(purchase)	-	-	-	-	-
Free cash flow	850	1,906	4,724	5,990	6,529
Other	(487)	(648)	415	519	616
Cash flow from investing	(6,303)	(5,734)	(2,918)	(2,815)	(2,718)
Equity raised/(repaid)	0	0	0	0	0
Debt raised/(repaid)	6,234	(1,050)	(2,022)	(4,197)	1,074
Other	(1,410)	(400)	(716)	(657)	(534)
Dividends paid	(4,243)	(3,146)	(3,847)	(4,163)	(4,538)
Cash flow from financing	581	(4,596)	(6,585)	(9,017)	(3,998)
Beginning cash	11,242	12,186	8,849	7,403	4,895
Ending cash	12,186	8,849	7,403	4,895	8,041
DPS	0.35	0.35	0.38	0.40	0.43

Balance sheet

HK$ in millions, year end Dec	FY12	FY13	FY14E	FY15E	FY16E
Cash and cash equivalents	12,186	8,849	7,403	4,895	8,041
Accounts receivable	5,722	6,568	7,214	7,933	8,786
Inventories	1,832	2,383	2,400	2,417	2,433
Others	1,697	3,889	3,889	3,889	3,889
Current assets	21,438	21,689	20,906	19,133	23,149
LT investments	25,411	25,954	26,733	27,535	28,361
Net fixed assets	42,454	47,648	49,131	50,555	51,925
Others	9,635	11,104	11,104	11,104	11,104
Total Assets	98,937	106,395	107,874	108,327	114,539
Liabilities					
Short-term loans	6,491	6,222	5,811	4,959	5,177
Payables	9,329	11,272	12,382	13,615	15,080
Others	1,433	1,767	1,000	1,085	1,176
Total current liabilities	17,253	19,262	19,194	19,659	21,432
Long-term debt	25,230	24,401	22,790	19,446	20,302
Other liabilities	6,104	6,362	6,362	6,362	6,362
Total Liabilities	48,587	50,025	48,345	45,467	48,096
Shareholder's equity	45,202	49,868	52,003	54,233	56,619
BVPS	5.20	5.22	5.18	5.16	5.39

Ratio Analysis

HK$ in millions, year end Dec	FY12	FY13	FY14E	FY15E	FY16E
EBITDA margin	49.0%	42.4%	41.7%	41.2%	40.5%
Net profit margin	29.2%	24.2%	24.2%	24.3%	24.3%
Sales per share growth	1.0%	3.0%	8.3%	2.5%	8.2%
Sales growth	11.1%	13.3%	13.7%	7.4%	8.2%
Net profit growth	25.4%	(11.1%)	13.4%	7.7%	8.5%
EPS growth	14.0%	(19.2%)	8.0%	2.9%	8.5%
Interest coverage (x)	17.5	16.0	18.7	21.7	28.3
Net debt to equity	43.2%	43.7%	40.8%	36.0%	30.8%
Sales/assets	0.3	0.3	0.3	0.3	0.3
Assets/equity	2.1	2.2	2.1	2.0	2.0
ROE	16.7%	14.4%	15.3%	15.8%	16.4%
ROCE	12.7%	10.8%	11.8%	12.8%	13.5%
ROA	7.9%	6.6%	7.3%	7.7%	8.2%

Source: Company reports and J.P. Morgan estimates.

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JPM Q-Profile

Hong Kong & China Gas Co. Ltd. (HONG KONG / Utilities)

As Of: 13-Mar-2015

Global Equity Quantitative Analysis

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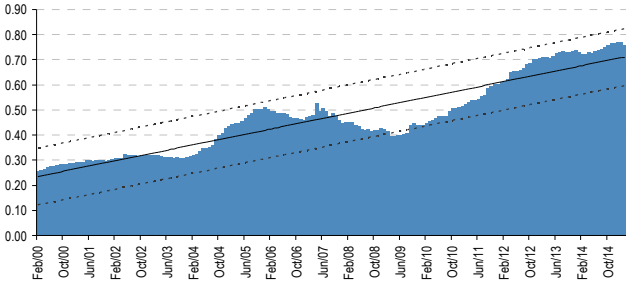
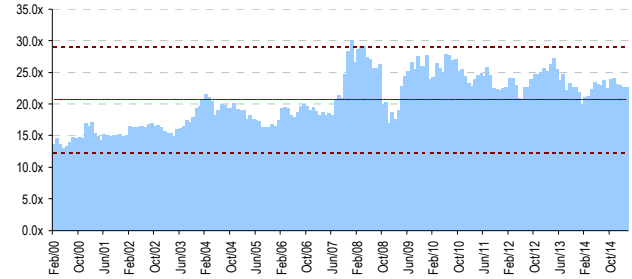
Local Share Price Current: 17.24

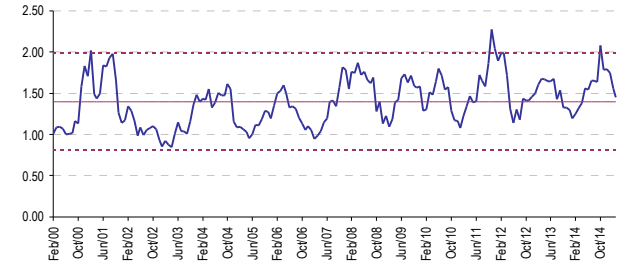
12 Mth Forward EPS Current: 0.76



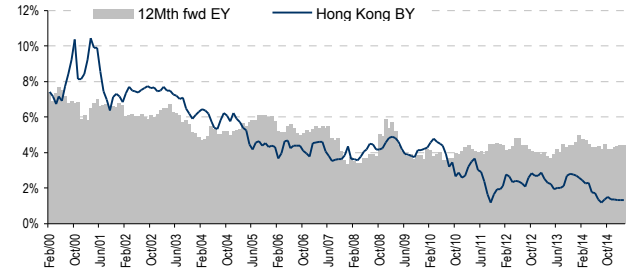
PE (1Yr Forward) Current: 22.7x



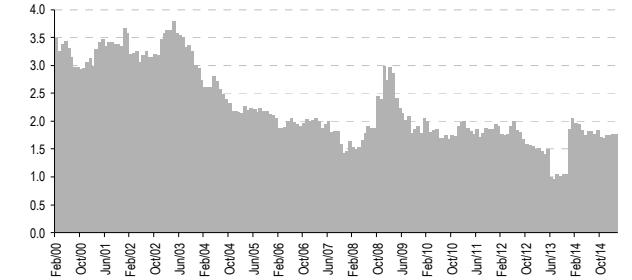
P/E Relative to Hong Kong Index Current: 1.45



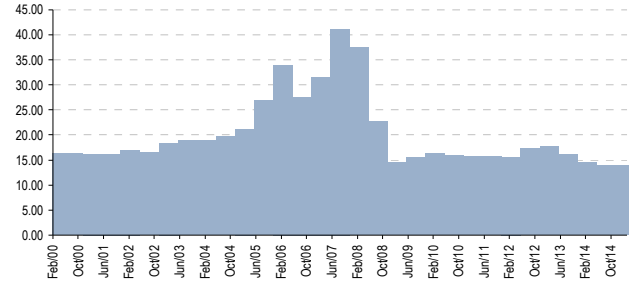
Earnings Yield (& Local Bond Yield) Current: 4%



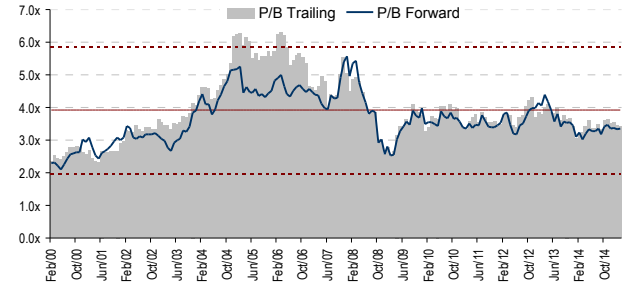
Dividend Yield (Trailing) Current: 1.77



ROE (Trailing) Current: 13.92



Price/Book (Value) Current: 3.4x



Summary

Hong Kong & China Gas Co. Ltd.									**As Of:**		13-Mar-15
HONG KONG		**TICKER**	**3 HK**						**Local Price:**		17.24
Utilities									**EPS:**		0.76
	Latest	**Min**	**Max**	**Median**	**Average**	**2 S.D.+**	**2 S.D. -**	**% to Min**	**% to Max**	**% to Med**	**% to Avg**
12mth Forward PE	**22.74x**	13.07	30.11	20.25	20.69	29.03	12.35	-43%	32%	-11%	-9%
P/BV (Trailing)	**3.41**	2.32	6.29	3.70	3.91	5.86	1.97	-32%	84%	8%	15%
Dividend Yield (Trailing)	**1.77x**	0.96	3.80	2.01	2.28	3.67	0.89	-46%	115%	13%	29%
ROE (Trailing)	**13.92**	13.92	41.09	16.52	20.09	34.34	5.84	0%	195%	19%	44%

Source: Bloomberg, Reuters Global Fundamentals, IBES CONSENSUS, JPMorgan Quantitative & Derivative Strategy

Other Companies Discussed in This Report (all prices in this report as of market close on 18 March 2015)
Cheung Kong Infrastructure (1038.HK/HK$64.60/Overweight)

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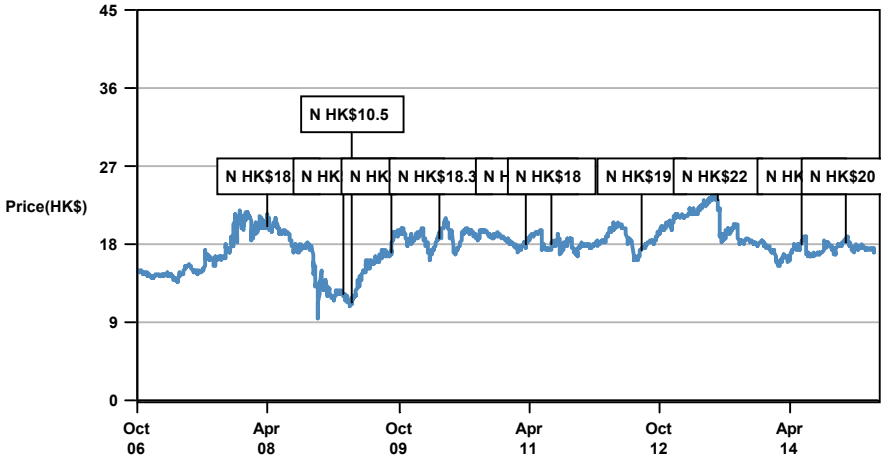
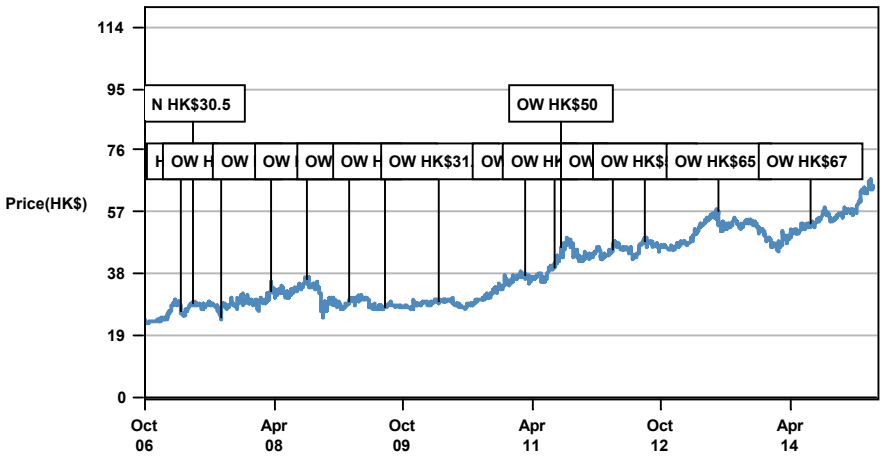
Hong Kong & China Gas (0003.HK, 3 HK) Price Chart



Date	Rating	Share Price (HK$)	Price Target (HK$)
26-Mar-08	N	20.09	18.50
12-Feb-09	N	12.14	13.60
18-Mar-09	N	11.40	10.50
27-Aug-09	N	16.98	15.30
17-Mar-10	N	18.76	18.30
16-Mar-11	N	18.02	19.40
07-Jul-11	N	18.04	18.00
12-Jul-12	N	17.22	19.00
29-May-13	N	23.05	22.00
19-May-14	N	18.10	19.00
19-Nov-14	N	18.22	20.00

Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends.
Initiated coverage Mar 26, 2008.

Cheung Kong Infrastructure (1038.HK, 1038 HK) Price Chart



Date	Rating	Share Price (HK$)	Price Target (HK$)
19-Apr-07	N	28.80	30.50
16-Aug-07	OW	24.90	28.50
17-Mar-08	OW	32.40	34.30
14-Aug-08	OW	36.25	37.00
12-Feb-09	OW	29.75	32.00
17-Jul-09	OW	27.80	31.00
04-Mar-10	OW	29.35	31.50
03-Mar-11	OW	37.50	42.00
07-Jul-11	OW	39.70	48.00
03-Aug-11	OW	46.15	50.00
09-Mar-12	OW	45.55	54.00
19-Jul-12	OW	47.80	56.00
29-May-13	OW	57.15	65.00
27-Jun-14	OW	53.45	67.00

Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends.
Initiated coverage Apr 19, 2007.

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IB clients*	56%	49%	33%
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IB clients*	75%	67%	52%

*Percentage of investment banking clients in each rating category.
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