Daiwa Capital Markets

17 March 2015

MEMO

Towngas China

1083 HK

Share price (17 Mar): **HKD7.21** 12-mth rating: **Buy (1)** Target price: **HKD9.30**

2014 results slightly miss on weak volume, but better 2015 expected

Dennis Ip, CFA
(852) 2848 4068
dennis.ip@hk.daiwacm.com

Kexin Zhu
(852) 2773 8535 (direct)
kexin.zhu@hk.daiwacm.com

■ What is new?

- Towngas China (TCCL) reported FY14 net profit of HKD1,054m. Stripping out the unrealised exchange loss (HKD141m loss in 2014 versus HKD160m gain in 2013), the recurring net profit was up 26% YoY, to HKD1,195m, 4% below our estimates and 3% below the Bloomberg consensus.

■ Result details

- Total revenue increased by 17% YoY, driven by 18% YoY growth in gas sales and a 16% YoY increase in connection fees. The increase in gas sales was driven by both volume growth (+10% YoY to 1.73bcm at subsidiary level) and increased gas sales prices (+7% YoY to HKD3.6/m3). Industrial, commercial and residential gas accounted for 59%, 17% and 24% of total volume of gas sold, respectively. The company had approximately 373,000 new household connections in 2014, up +20% YoY from 2013.
- The revenue mix of gas sales vs. connection fees (79%:21%) was roughly in line with 2013 (78%:22%), and segment margins were 7.6% and 44.5%, respectively, in line with 2013 (8.1% and 44.0%, respectively).
- Overhead costs (HKD1,688m) increased by 11% YoY in 2014, mainly due to business development together with escalations in wages and inflation. Staff costs, depreciation and amortisation expenses and other expenses rose by 17% and 21% YoY, respectively.
- The EBIT margin dropped slightly from 13.8% in 2013 to 13.5% in 2014.
- Finance costs (HKD174m) increased by 6% YoY. This rise reflected the increase in loans due to the acquisition of new projects in 2014.
- The effective tax rate increased slightly from 23.8% in 2013 to 22.9% in 2014, but the minority rate increased from 9.8% in 2013 to 10.7% in 2014, due to higher earnings growth from the subsidiary projects.
- The net margin dropped from 16.5% in 2013 to 13.4% in 2014.
- DPS is HKD0.10 for 2014 (HKD0.08 in 2013), representing a payout ratio of 25% (19% in 2013).
- The net debt to equity ratio increased from 26% in 2013 to 36% in 2014, including the loan from HKCG.
- The company acquired 9 new projects in 2014. The total gas consumption of these projects is expected to reach approximately 800mcm in five years. In addition, the company also developed a new project in early 2015, and total gas consumption of this project is expected to reach approximately 280mcm in five years. Total additional gas sales at 1.08cm from these 10 projects represent an additional 25% of our 2020E subsidiary gas sales volume

■ Tele-conference key takeaways and our views

- **3Q14 gas-sales volume growth flat, but recovered in 4Q14. For FY14, TCCL's gas sales volume rose by 10% YoY, down from 14% YoY (at the subsidiary level) for 1H14.** Therefore, 2H14 gas sales volume (at the subsidiary level) only increased by 6% YoY, mainly due to flat growth in 3Q14 but the recovery to 10% YoY growth in 4Q14. According to management, the gas sales volume for January 2015 was also maintained at 10% YoY growth. Management attributed the significant slowdown to the poor economy, especially in industrial provinces such as Shandong, which only achieved 4-5% YoY gas sales volume growth in FY14. Anhui, Zhejiang and the Northeast (driven by Jilin and Liaoning) achieved 12-13% YoY gas sales volume growth.
- **2015 volume growth should recover on the coming city-gate tariff cut for incremental-volume non-residential gas.** Despite the recent low oil price, as management sees the substitution effect of natural gas with LPG in some provinces, gas sales volume growth was maintained a 10% YoY in January 2015. While management only expects a conservative double-digit gas sales volume growth in 2015, we believe the coming city-gate tariff cut for incremental-volume gas, by CNY0.44/m3 (or 15%), effective April 2015, could help to recover the gas sales volume

growth to the mid-teens. According to management, the northeast is in the process of replacing the coal-gas with natural gas, which should be able to result at least low-teens growth.

- **Margin maintained from last city-gate tariff hike.** The unit segment dollar margin was maintained at HKD0.27/m3, despite a slight depreciation in the CNY. Therefore, the unit segment dollar margin actually expanded slightly in FY14. According to management, 96% of the affected piped gas volume was successfully passed through from the last city-gate tariff hike in September 2014. Despite a city-gate tariff adjustment (cut in incremental volume, with a blended tariff and base volume unchanged) in April 2015, management believes the impact would be within a few cents, and Towngas China plans to ask for the retail tariff to remain broadly unchanged.
- **More positive catalysts for the China gas distribution sector in 2015.** Management expects the tiered-residential tariff policy to be implemented in 2015, and as such we see the potential for margin expansion due to residential gas sales. In addition, we believe there could be another 10% cut in the non-residential city-gate tariff by 3Q15, should the oil price stay at current low levels, to further boost gas sales volume growth in 2H15.
- **Gas connection up 20% YoY, a positive surprise.** While TCCL had only 30% of the households from old residential buildings (50% for peers), TCCL still achieved 20% YoY growth in residential household connections (peers: 0-10%, TCCL 1H14: 11%), mainly attributable to the recovery in the property market in recession areas. We expect the coal-to-gas projects to support residential household connections, even though management targets conservative flat growth.
- **Potential asset injection uncertain.** Despite management's reiteration that TCCL would ultimately be the investment vehicle for HKCG's city-gas projects in China, there is no exact timetable. We believe TCCL's strong balance sheet (36% net-debt-to-equity including HKCG's loan, peers' 27-53%) should enable TCCL to execute the long-awaited asset injection. Parent HKCG has 35 city-gas projects available to be injected into TCCL. However, the wide forward PER valuation gap, TCCL's 14x versus HKCG's 20x, could make it difficult to obtain both minority shareholders' approval and therefore we don't expect the asset injection to happen in the near term.
- **Lower-than-expected new city-gas projects.** TCCL secured 9 new city-gas projects in 2014 (1H14: 8 projects), with only 1 city-gas project so far in 2015, which lags behind the 8-10 city-gas projects per annum targeted by management. TCCL has 104 city-gas projects YTD. We believe TCCL is getting more difficult to secured new city-gas projects given CR Gas (1193 HK, Outperform) have resumed its aggressive M&A during 1Q15, with 25 city-gas projects bagged with a consideration of HKD1.6bn.

■ Valuation

TCCL's 14x 2015E PER is at the low end of the peer range of 12-17x, which we see as unjustified. Our 12-month DCF-based target price for TCCL is HKD9.30. The main risk to our Buy (1) rating is lower-than-expected gas sales caused by economic downturn.

Our pecking orders of China gas distribution sector is TCCL, China Resources Gas, Beijing Enterprises Holdings, China Gas and ENN Energy.

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■ TCCL: 2014 results

(HKDm)	2013	2014	YoY	Comments
Turnover	6,716	7,882	17%	
- Gas sales	*5,265*	*6,205*	*18%*	*18% YoY growth on gas sales revenue higher than 10% YoY growth on subsidary gas sales volume due to increase in gas tariff on city-gate tariff hike for non-residential piped gas*
- Gas connection	*1,451*	*1,677*	*16%*	
Operating expenses	(5,791)	(6,816)	18%	
Cost of inventories sold	(4,686)	(5,604)	20%	
Staff costs	(671)	(788)	17%	
Depreciation and amortization	(331)	(402)	22%	
Other operating expenses	103	23	-78%	
EBIT	925	1,066	15%	
EBITDA	1,256	1,468	17%	
Other incomes	246	14	-94%	
- Exchange Gain	*160*	*(141)*	*-188%*	*RMB depreciation*
- Dividend income from AFS (Chengdu)	*58*	*66*	*14%*	
- Interest income	*60*	*50*	*-17%*	
- Others	*(32)*	*39*	*-223%*	
Share of results of associates	336	347	3%	
Share of results of JCE	265	278	5%	
Finance costs	(164)	(174)	6%	
PBT	1,609	1,531	-5%	
Taxation	(383)	(350)	-8%	
PAT	1,226	1,181	-4%	
Minoirty interest	120	127	6%	
Net profit attributable to shareholders	1,106	1,054	-5%	
Net profit attributable to shareholders, net of FX impact and disposal gain	946	1,195	26%	
Dividend	209	263	26%	
Weighted number of shares for dulited EPS	2,605	2,623	1%	
EPS	0.42	0.40	-5%	
EPS, net of FX impact	0.36	0.46	25%	
DPS	0.08	0.10	25%	

Source: Company, Daiwa

■ TCCL: 2014 key financials

Key Financials	2013	2014	YoY
EBITDA margin	18.7%	18.6%	-.1pp
EBIT margin	13.8%	13.5%	-.2pp
Net margin	16.5%	13.4%	-3.1pp
Net margin (recurring)	14.1%	15.2%	1.1pp
Operating expenses before D&A -to- revenue	81.3%	81.4%	.1pp
Effective tax rate	23.8%	22.9%	-.9pp
Dividend payout	18.9%	25.0%	6.1pp
Net debt-to-equity	26.4%	35.9%	9.6pp

Source: Company, Daiwa

■ **TCCL: 2014 segment metric**

(HKDm unless otherwise stated)	2013	2014	YoY	
Segment Metric				
Gas sales				
Turnover	5,265	6,205	18%	
Segment profit	427	471	10%	
Segment margin	8.1%	7.6%	-.5pp	
Segment proportion	40.1%	38.7%	-1.4pp	
Sales volume (Total), mn cm	5,950	6,511	9%	
Sales volume (Total) exclude Chengdu, mn cm	4,820	5,293	10%	
Sales volume (Consolidated), mn cm	1,570	1,726	10%	1H14 YoY gas sales volume growth at subsidiary level was 14%, an significant drop for 2H14 at 6% YoY growth due to economic slowdown (such as Shandong which only achieved 4-5% FY14 YoY gas sales volume growth, however, 4Q14-January 15 was recovered at 10% YoY gas sales volume growth according to management
- Commercial	*262*	*293*	*12%*	
- Industrial	*918*	*1,018*	*11%*	
- Residential	*389*	*414*	*6%*	
Commercial Gas Sales Proportion	17%	17%	.3pp	
Industrial Gas Sales Proportion	59%	59%	.5pp	
Residential Gas Sales Proportion	25%	24%	-.8pp	
Segment profit per unit gas sales (HKD/cm)	0.27	0.27	0%	Margin maintained despite the another round of city-gate tariff hike in September 2014, while TCCL only able to pass through 96% of the cost
ASP, HKD/cubic meter	3.35	3.60	7%	Increase in ASP after the non-residential city-gate gas tariff hike
Gas connection				
Turnover	1,451	1,677	16%	
Segment profit	638	746	17%	
Segment margin	44.0%	44.5%	.5pp	
Segment proportion	59.9%	61.3%	1.4pp	
Number of connection (Total)	880,000	970,000	10%	
Number of connection (Consolidated)	310,000	373,000	20%	1H14 YoY gas connection growth at subsidiary level was 11%, an significant increase for 2H14 with 26% YoY growth due to better property market in 4Q14

Source: Company, Daiwa

In the interests of timeliness, this document has not been edited.

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- In addition to the purchase price of a financial instrument, we will collect a trading commission* for each transaction as agreed beforehand with you. Since commissions may be included in the purchase price or may not be charged for certain transactions, we recommend that you confirm the commission for each transaction.
- In some cases, we may also charge a maximum of ¥ 2 million (including tax) per year as a standing proxy fee for our deposit of your securities, if you are a non-resident of Japan.
- For derivative and margin transactions etc., we may require collateral or margin requirements in accordance with an agreement made beforehand with you. Ordinarily in such cases, the amount of the transaction will be in excess of the required collateral or margin requirements.
- There is a risk that you will incur losses on your transactions due to changes in the market price of financial instruments based on fluctuations in interest rates, exchange rates, stock prices, real estate prices, commodity prices, and others. In addition, depending on the content of the transaction, the loss could exceed the amount of the collateral or margin requirements.
- There may be a difference between bid price etc. and ask price etc. of OTC derivatives handled by us.
- Before engaging in any trading, please thoroughly confirm accounting and tax treatments regarding your trading in financial instruments with such experts as certified public accountants.

* The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

When making an actual transaction, please be sure to carefully read the materials presented to you prior to the execution of agreement, and to take responsibility for your own decisions regarding the signing of the agreement with us.

Corporate Name:	Daiwa Securities Co. Ltd.
	Financial instruments firm: chief of Kanto Local Finance Bureau (Kin-sho) No.108
Memberships:	Japan Securities Dealers Association, The Financial Futures Association of Japan
	Japan Securities Investment Advisers Association
	Type II Financial Instruments Firms Association