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HONG KONG RESEARCH
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THE HONG KONG AND CHINA GAS COMPANY LIMITED (中華煤氣)

Sector	: Utilities	Chairman	: Dr. Lee Shau Kee
HKSE Code	: 00003		
Market Price	: HK$17.68(19/03/2015)	Managing Director	: Mr. Chan Alfred Wing Kin
Shares Issued	: 10,512m		
Mkt. Cap.	: HK$185,852m	CFO	: Mr. Ho John Hon Ming
52 weeks Hi/ Lo	: HK$18.90 / HK$14.245		
HSI	: 24,468.89 (19/03/2015)		
Main Business	: Towngas supply		

SUMMARY OF THE FINAL RESULTS FOR THE YEAR ENDED 31ST DECEMBER 2014

Final Results Highlights

	FY2014 HK$ million	FY2013 HK$ million	*Change*
♦ Revenue	29,890	26,280	*+13.7%*
♦ **Operating profit after tax**	**6,960**	**6,320**	***+10.1%***
♦ Exchange gain / (loss)	(270)	(310)	*-12.9%*
♦ Property revaluation gain	420	230	*+82.6%*
♦ **Profit attributable to shareholders**	**7,109**	**6,854**	***+3.7%***
♦ EPS	0.676	0.652	*+3.7%*
♦ Final DPS	0.23	0.23	*+0.0%*
♦ Interim DPS	0.12	0.12	*+0.0%*
♦ Total DPS	0.35	0.35	*+0.0%*

- Hong Kong & China Gas (“HKCG” or “the Company”) reported a net profit of HK$7,109m in FY14, up 3.7% y-o-y. The mainland utility business continues to drive the company’s earnings growth with operating profit of HK$6,960m, up 10.1% y-o-y. Nevertheless, the FY14 earnings were lower than the consensus estimates of HK$7,227m, attributable to the lower-than-expected income from its New Energy segment.
- Despite higher net profit, Management maintained the final dividend at HK$0.23 for FY14. Together with the interim dividend of HK$0.12, total dividend per share amounted to HK$0.35, representing a dividend payout ratio of 51.8% (FY13: 53.7%). Similar to the previous few years, HKCG declared one bonus share for every 10 shares.
- As of 31st December 2014, HKCG recorded net debts totalling HK$18,378m (31st December 2013: HK$20,485m), leaving its net debt-to-total equity ratio of 29.5%, down from 36.3% a year ago.

Business Review

Operating profit after tax by businesses

	2014 (HK$ million)	%	2013 (HK$ million)	%	Change
HK Utilities	*2,690*	*39%*	*2,670*	*42%*	+0.7%
Mainland Utilities	*3,430*	*49%*	*2,960*	*47%*	+15.9%
New Energy	*510*	*7%*	*520*	*8%*	-1.9%
	6,630		*6,150*		***+7.8%***
Net financial income	*330*	*5%*	*170*	*3%*	
Total	**6,960**	*100%*	**6,320**	*100%*	***+10.1%***

- Net profit for **Hong Kong gas business** increased 0.7% y-o-y to HK$2,690m, driven by 1.0% gas sales volume growth. The sluggish growth in gas sales was attributable to increasing number of inbound tourists and good gas sales in commercial & industrial sectors, which were partly offset by the adverse impact of higher average temperature in 2014. As at the end of 2014, the number of customers was 1,819,935, an increase of 21,204 compared to 2013.

- Net profit from **China utilities**, including the contribution from Towngas China (01083.HK, 62.39%-owned subsidiary of HKCG) was HK$3,430m, up 15.9% y-o-y. During FY14, 83% of the profit came from city gas projects, 8% from midstream gas projects and 9% from water projects. The higher earnings in FY14 were driven by 14% increase in total gas sales volume as well as 18% y-o-y connection fee income growth. HKCG added 8 new city gas projects in 2014, bringing its total to 127 projects (33 under HKCG and 94 under Towngas China) across 23 provinces and municipalities as at the end of 2014.

- Net profit from **New Energy,** which comprises of aviation fuel facility in Hong Kong, coal-related projects in China and oilfield project in Thailand, dropped 1.9% y-o-y to HK$510m. Given HKCG's New Energy business mainly serves an alternative energy source against traditional energy sources such as oil and coal, the drastic fall in the international oil prices during 2H14 negatively impacted the profitability of HKCG's projects.

Outlook & Prospect

- ***Unexciting gas business in Hong Kong*** Being the sole gas supplier in Hong Kong, HKCG has been operating as a monopoly, with an 86% local coverage as at end-2014. Following the tariff hike in April 2013, HKCG will likely maintain the current tariff until 2016 as HKCG historically increases its basic tariff every three years. Therefore, Hong Kong gas business is likely to remain at low single-digit growth in 2015. HKCG will likely be very careful about raising the basic tariff even after two years so as to avoid political pressure on regulating its return.

- ***Mainland utilities continue to be the growth driver*** Management commented HKCG recorded a lower dollar margin in China in 2H14 as there was a delay in cost pass-through, following the rise in the gate price of natural gas (i.e. the cost of natural gas) for non-residential gas sector effective from 1st September 2014. Currently, all projects have passed through the cost increases and therefore, margin improvement is likely to be seen in 2015. Meanwhile, there will be a cut in natural gas gate price effective from 1st April 2015. In terms of gas sales, Management guided for a target of 17bn m3 in 2015, up 12% y-o-y (vs 14% in FY14), and expected a double-digit growth for the next five years. With acquisitions of new projects slowing (from 12 additional projects in FY13 to 8 projects in FY14), HKCG will have to rely more on organic growth and new connections at existing projects in the future.

- ***New energy business dragged by oil prices*** New Energy is the riskiest yet fastest-growing segment among HKCG's operations. Since the oil prices continue to fall in 1Q15, we believe HKCG's New Energy segment has not yet seen the worst. HKCG's PRC coal mining business and the oil business in Thailand could be further squeezed and HKCG should expect another earning decline in this segment in 2015. Despite the tough external environment, Management plans to continue investing 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.

- ***Valuation*** HKCG is becoming less of a utility company and more like an energy play with increased risks to fuel prices. Given the lukewarm Hong Kong gas operation and the decelerating mainland city-gas business, new energy will likely become the key growth driver for HKCG in the near term. However, HKCG's 2015E P/E of 24x far exceeds peer averages of China gas utilities (16x) and Hong Kong utilities (15x). We are concerned its current rich valuation does not allow much downside risk for the success of its new energy projects. We accordingly recommend a "Sell" rating for the counter.

Recommendation: ***Sell***

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