

PetroChina - H

Upstream profitability sustainable; natural gas import/chemical losses to narrow; pipeline restructuring soon

We believe PetroChina's management update is likely to be taken positively by the market, with its focus on cost optimization, restructuring and environmental efficiency. We have been surprised at PetroChina's ability to sustain upstream profitability, and there is clearly "low-hanging fruit" in terms of cost-cutting.

- **Positive on upstream profitability:** PetroChina indicated continued upstream profitability for the first two months in FY15. Cost-cutting remains a focus (the company targets flat lifting costs) with field managers' salaries linked to profit and squeezing mature fields (e.g., Liaohe/Jilin).
- **M&A still on the agenda:** With a c16-year proven reserve life and expectations of low oil prices for a long period of time, PetroChina sees good M&A opportunities. The emphasis was on conventional assets, rather than oil sands/CBM, with potential for equity/asset swaps with large firms or M&A with small, cash-strapped companies.
- **Plans for restructuring:** Pipeline restructuring is extended to the majority of the domestic oil/gas pipeline network (not just west/east parts of the West-East gas pipeline), subject to government approval. The company is looking at marketing reform, with pilot programs in Xinjiang and two Eastern provinces.
- **Chemicals recovery:** PetroChina expects to reduce its chemicals loss by c30% (implied cRmb12bn loss in FY15) and sees an improving chemicals market.
- **Natural gas loss to narrow:** PetroChina forecasts an LNG/pipeline import natural gas loss of Rmb15-20bn this year (was Rmb35bn in FY14), which reflects not only pricing impact, but also perhaps lower LNG volumes.
- **Minor changes to FY15E/17E EPS; maintain Dec-15 PT and rating.**

PetroChina - H (Reuters: 0857.HK, Bloomberg: 857 HK)

Rmb in mn, year-end Dec	FY12A	FY13A	FY14A	FY15E	FY16E
Revenue (Rmb mn)	2,195,296	2,258,124	2,282,962	1,368,253	1,552,063
Net Profit (Rmb mn)	115,326	129,599	107,172	59,589	78,468
EPS (Rmb)	0.63	0.71	0.59	0.33	0.43
DPS (Rmb)	0.32	0.32	0.26	0.15	0.19
Revenue Growth (%)	9.6%	2.9%	1.1%	(40.1%)	13.4%
EPS Growth (%)	(13.3%)	12.4%	(17.3%)	(44.4%)	31.7%
ROCE	9.7%	8.4%	7.7%	4.2%	5.0%
ROE	11.2%	11.8%	9.3%	4.9%	6.2%
P/E	10.6	9.4	11.4	20.5	15.6
P/BV	1.2	1.1	1.0	1.0	1.0
EV/EBITDA	7.8	7.8	7.6	11.1	9.4
Dividend Yield	4.7%	4.8%	3.9%	2.2%	2.9%

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

Neutral

0857.HK, 857 HK

Price: HK\$8.35

Price Target: HK\$8.20

Hong Kong

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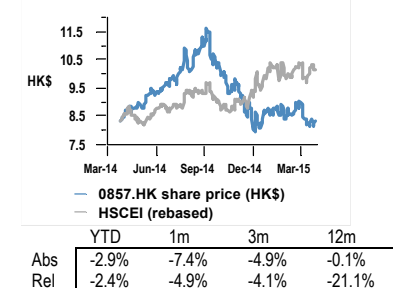
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Price Performance



Company Data

Shares O/S (mn)	21,099
Total Market Cap(A+H) (HK\$ mn)	2,548,917
Total Market Cap(A+H) - USD (\$ mn)	328,689
Price (HK\$)	8.35
Date Of Price	26 Mar 15
Free Float(%)	98.6%
3M - Avg daily vol (mn)	92.99
3M - Avg daily val (HK\$ mn)	800.27
3M - Avg daily val (\$ mn)	103.2
HSCEI	11,919.69
Exchange Rate	7.75
Price Target End Date	31-Dec-15

See page 7 for analyst certification and important disclosures, including non-US analyst disclosures.

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<p>Key catalysts for the stock price:</p> <p>1) 1Q earnings announcement (watch for refining/chemicals improvement and upstream profitability)</p> <p>2) Pipeline/marketing restructuring</p>	<p>Upside risks to our view:</p> <p>A sharp increase in crude oil prices, driving E&P profits</p>	<p>Downside risks to our view:</p> <p>A sharp fall in oil prices, recent natural gas price hikes not being passed through to customers and any further rises, a higher import burden and weak chemicals profitability from lower demand and margins</p>
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Key financial metrics	FY14	FY15E	FY16E	FY17E
Revenues (LC)	2,282,962	1,368,253	1,552,063	1,751,615
Revenue growth (%)	1%	(40%)	13%	13%
EBITDA (LC)	347,296	252,269	305,746	349,062
EBITDA margin (%)	15%	18%	20%	20%
Tax rate (%)	24%	22%	22%	22%
Net profit (LC)	107,172	59,589	78,468	81,778
EPS (LC)	0.586	0.326	0.429	0.447
EPS growth (%)	(17%)	(44%)	32%	4%
DPS (LC)	0.264	0.147	0.193	0.201
Operating cash flow (LC mn)	335,056	147,034	228,203	255,908
Free cash flow (LC mn)	59,821	(99,484)	6,490	47,624
Interest cover (X)	16.0	10.2	11.1	12.2
Net margin (%)	5%	4%	5%	5%
Sales/assets (X)	1.0	0.6	0.6	0.7
Debt/equity (%)	41%	47%	51%	53%
Net debt/equity (%)	35%	44%	48%	48%
ROE (%)	9%	5%	6%	6%

Key model assumptions	FY14	FY15E	FY16E	FY17E
Oil price assumption	99	49	57	65
Total oil and gas production (000 boe/d)	3,835	3,973	4,015	4,088

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

Sensitivity analysis	EBITDA		EPS	
Sensitivity to	FY15E	FY16E	FY15E	FY16E
Impact of each +US\$5/bbl	5%	5%	5%	5%

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

Asia Oil & Gas coverage comparative metrics

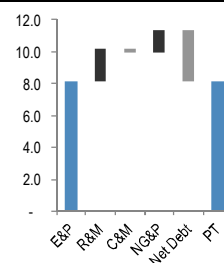
Company name	Rating	PT (LC)	CMP (LC)	Pot. upside to PT (%)	Market cap (\$ B)	P/E (x)		P/B (x)		EV/EBITDA (x)		YTD perf (%)
						15Y	16Y	15Y	16Y	15Y	16Y	
PETROCHINA-H	N	8.20	8.35	(1.8)	335.3	20.5	15.6	1.0	1.0	11.1	9.4	(2.9)
SINOPEC CORP-H	N	5.70	6.05	(5.8)	119.0	21.1	13.8	0.9	0.9	8.3	7.1	(3.2)
CNOOC	UW	9.00	10.56	(14.8)	60.8	19.7	11.9	1.2	1.3	5.0	4.1	1.1
SINOPEC SHANG-H	UW	1.50	2.68	(44.0)	7.7	30.7	17.9	1.2	1.2	14.6	13.9	18.1
CHINA OILFIELD-H	UW	10.60	12.32	(14.0)	13.8	12.7	11.9	1.0	1.0	11.7	11.0	(8.5)
INPEX CORP	OW	1,560	1,375	13.5	16.9	23.1	18.8	0.8	0.7	5.3	4.1	2.2
OIL & NATURAL GA	UW	300	302	(0.5)	41.0	12.2	9.6	1.3	1.2	5.9	4.7	(12.3)
CAIRN INDIA	N	235	223	5.4	6.6	5.6	11.1	0.7	0.6	2.7	4.5	(6.7)
PTT PCL	N	330	326	1.2	28.6	11.7	10.7	1.2	1.2	6.0	5.9	0.6
PTT EXPL & PROD	UW	95	112	(14.8)	13.6	17.6	17.5	1.0	1.0	3.8	4.1	(0.4)
PETROCHINA CO-A	UW	6.50	11.99	(45.8)	335.3	36.1	27.4	1.7	1.7	11.1	9.4	10.9
CHINA PETROLEU-A	UW	4.60	6.44	(25.5)	119.0	28.0	18.4	1.2	1.1	8.3	7.1	(0.8)
SINOPEC SHANG-A	UW	1.20	5.55	(78.4)	7.7	79.3	46.3	3.1	3.0	14.6	13.9	28.2
CHINA OILFIELD-A	UW	8.50	22.86	(62.8)	13.8	29.3	27.5	2.3	2.2	11.7	11.0	10.1

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

Valuation and price target basis

Our Dec-15 PT for PetroChina-H of HK\$8.20 is based on a sum-of-the-parts methodology, whereby we calculate a DCF-based value for each business segment. Debt and financial liabilities are deducted at book value.

Price target breakdown – PetroChina-H



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

JPMe vs. consensus, change in estimates

	FY15E	FY16E
EPs		
JPMe old	0.288	0.443
JPMe new	0.326	0.429
% chg	13%	(3%)
Consensus	0.294	0.509

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

Cost control and restructuring focus

PetroChina's FY14 analyst briefing highlighted the company's strategy to accelerate further cost optimization (already undertaken in the wake of the management

changes from late 2013). There was more emphasis on energy and environmental efficiency, providing details on coal, water and emissions saved, and an acknowledgement that oil prices will remain low for a long period and that Chinese oil/gas demand growth continues to slow down. Key points:

- **FY15 production targets as expected:** Guidance for oil production growth is down c2% y/y, while natural gas is up 6%, broadly in line with our expectations. RRR >0.7 based on US\$70/bl.
- **Natural gas pricing adjustment:** PetroChina expect the NDRC's recent announcement to adjust natural gas prices (see note) to "exert some negative impact on the business," but to be a benefit in the long run as the country moves toward market-based pricing.
- **Impairment risks remain:** PetroChina sees no large impairment of upstream assets in the current oil price environment.
- **Import gas losses to narrow:** PetroChina's forecast of an LNG/pipeline import natural gas loss of Rmb15-20bn this year (was Rmb35bn in FY14) not only reflects a pricing impact (natural gas import prices lag oil prices by around nine months), but also perhaps lower LNG volumes (LNG imports may be <6bcm in FY15 vs. 7.3bcm in FY14).
- **Upstream performance linked to pay:** The company seems to have linked operational/profitability performance within its upstream to production manager salaries. The company also attributes its upstream performance to efforts made to enhance oil recovery at mature fields (e.g., Liaohe/Jilin), as well as a decrease in administration expenses, transportation and marketing cost.
- **Pipeline/marketing restructuring:** PetroChina reiterated the government's view that the market should play a decisive role in resource allocation in China. Further optimization of its pipeline assets will be extended to the majority of the gas and oil pipeline portfolio (not just the eastern/western part of West East Pipeline network). However, the company stated that any restructuring must comply with the government and at an acceptable return. A marketing pilot program has been initiated at Xianjiang and two provinces in eastern China. Both West and East models will be evaluated to see which offers the best potential; presumably, this relates to which areas present the best non-fuels growth.
- **Positive on chemicals recovery:** While the company guided to a slight increase in chemical capex, which relates to projects starting up later this year, capex will be reduced in the long term. Surprisingly, PetroChina is seeing a seasonal pickup in domestic chemicals demand (e.g., fertilizer), with tightening supply as refineries undergo planned maintenance, limiting chemical supply, "coal-to-chemicals competitive edge weakening" in current oil prices, chemicals losses are likely to decline into 2Q15. The company shut down 30 uneconomical units last year and plans to make more efforts to reduce losses (guides to a 30% loss reduction in FY15).

Adjusting FY15E/17E EPS by an average 1%; maintain PT and ratings

We have adjusted our FY15/17 EPS forecasts by an average of 1% to reflect higher-than-expected refining profitability and weaker-than-expected chemicals profitability.

We maintain our Neutral view and Dec-15 PT for PetroChina-H of HK\$8.20, based on DCF for the different segments, with a WACC of 10.5%.

Table 1: Sinopec EPS estimate revisions

Rmb	New	Old	Consensus	Change	Vs. consensus
15Y	0.33	0.29	0.29	13%	11%
16Y	0.43	0.44	0.51	(3%)	(16%)
17Y	0.45	0.48	0.84	(7%)	(47%)

Source: J.P. Morgan estimates. % change refers to new estimates.

Investment Thesis, Valuation and Risks

PetroChina - H (Neutral; Price Target: HK\$8.20)

Investment Thesis

PetroChina is the largest oil company in China and one of the largest globally. It is integrated with E&P, R&C, marketing and pipelines (NGP). In 2014, crude production was 2.6mn BOPD and natural gas 1.5mn BOEPD, refining throughput 2.75mn BOPD and chemical production 21.5mn tonnes, and it operated over 40,000km of pipelines (crude, products and natural gas). PetroChina has proven reserves of 23.4bn BOE (55% natural gas, 68% of crude is developed). Major profit drivers are crude prices and refining margins in China. Our Neutral view of PetroChina-H is based on:

- **Shift in energy portfolio to be rewarded** – We expect investor focus to be on the company's ability to strategically shift its energy portfolio away from low-return assets via asset divestments. We think visibility on asset divestments will lead to outperformance relative to local peers.
- **Headwinds from global oil market; downstream drag on earnings** – With crude oil markets pressured, we believe the upstream-focused PetroChina will be in a period of lackluster returns; additionally, the downstream segment looks to be a continued burden (1Q15 theoretical China GRMs beginning in negative territory; chemicals look on track to continue to be a loss-making business).

Valuation

Our Dec-15 PT of HK\$8.20 is based on a sum-of-the-parts methodology, whereby we calculate a DCF-based value (WACC 10.5%, terminal g 2%) for each business segment (upstream, refining, chemicals and marketing) to give our total NAV. Debt and financial liabilities are deducted at book value.

Risks to Rating and Price Target

Downside risks to our rating and price target include a sharp fall in oil prices, recent natural gas price hikes not being passed through to customers and no further rises, a higher import burden and weak chemicals profitability from lower demand and margins. Upside risks include a sharp increase in crude oil prices, driving E&P profits.

PetroChina - H: Summary of Financials

Income Statement						Cash flow statement					
Rmb in millions, year end Dec	FY13	FY14	FY15E	FY16E	FY17E	Rmb in millions, year end Dec	FY13	FY14	FY15E	FY16E	FY17E
Revenues	2,258,124	2,282,962	1,368,253	1,552,063	1,751,615	EBIT	169,782	169,833	97,449	124,925	129,703
% change Y/Y	2.9%	1.1%	(40.1%)	13.4%	12.9%	Depr. & amortization	163,365	177,463	154,820	180,820	219,359
EBITDA	333,147	347,296	252,269	305,746	349,062	Change in working capital	20,300	25,491	(87,098)	(53,819)	(68,519)
% change Y/Y	2.0%	4.2%	(27.4%)	21.2%	14.2%	Taxes	(35,789)	(37,731)	(18,138)	(23,723)	(24,635)
EBIT	169,782	169,833	97,449	124,925	129,703	Cash flow from operations	327,938	335,056	147,034	228,203	255,908
% change Y/Y	(2.7%)	0.0%	(42.6%)	28.2%	3.8%	Capex	(318,074)	(291,729)	(266,000)	(243,290)	(230,790)
EBIT Margin	7.5%	7.4%	7.1%	8.0%	7.4%	Disposal/(purchase)	-	-	-	-	-
Net Interest	(20,859)	(21,723)	(24,817)	(27,487)	(28,670)	Net Interest	(20,859)	(21,723)	(24,817)	(27,487)	(28,670)
Earnings before tax	159,203	156,759	84,361	110,341	114,580	Other	51,564	891	0	0	0
% change Y/Y	(4.6%)	(1.5%)	(46.2%)	30.8%	3.8%	Free cash flow	26,034	59,821	(99,484)	6,490	47,624
Tax	(35,789)	(37,731)	(18,138)	(23,723)	(24,635)	Equity raised/(repaid)	0	0	0	0	0
as % of EBT	22.5%	24.1%	21.5%	21.5%	21.5%	Debt raised/(repaid)	12,571	82,796	(18,515)	0	35,179
Net income (reported)	129,599	107,172	59,589	78,468	81,778	Other	33,510	(78,881)	103,963	50,763	(11,444)
% change Y/Y	12.4%	(17.3%)	(44.4%)	31.7%	4.2%	Dividends paid	(58,320)	(48,227)	(26,815)	(35,310)	(36,800)
Shares outstanding	183,021	183,021	183,021	183,021	183,021	Beginning cash	43,395	51,407	73,778	25,175	38,443
EPS (reported)	0.71	0.59	0.33	0.43	0.45	Ending cash	51,407	73,778	25,175	38,443	64,043
% change Y/Y	12.4%	(17.3%)	(44.4%)	31.7%	4.2%	DPS	0.32	0.26	0.15	0.19	0.20
Balance sheet						Ratio Analysis					
Rmb in millions, year end Dec	FY13	FY14	FY15E	FY16E	FY17E	Rmb in millions, year end Dec	FY13	FY14	FY15E	FY16E	FY17E
Cash and cash equivalents	51,407	73,778	25,175	38,443	64,043	EBITDA margin	14.8%	15.2%	18.4%	19.7%	19.9%
Accounts receivable	78,387	65,931	41,490	54,124	70,245	EBIT margin	7.5%	7.4%	7.1%	8.0%	7.4%
Inventories	227,017	165,977	104,449	132,698	167,731	Net margin	5.7%	4.7%	4.4%	5.1%	4.7%
Others	74,142	85,622	69,183	85,769	105,934	Sales per share growth	2.9%	1.1%	(40.1%)	13.4%	12.9%
Current assets	430,953	391,308	240,297	311,034	407,953	Sales growth	2.9%	1.1%	(40.1%)	13.4%	12.9%
LT investments	-	-	-	-	-	Net profit growth	12.4%	(17.3%)	(44.4%)	31.7%	4.2%
Net fixed assets	1,648,823	1,747,691	1,898,778	1,953,748	1,957,679	EPS growth	12.4%	(17.3%)	(44.4%)	31.7%	4.2%
Total Assets	2,342,110	2,405,473	2,407,169	2,535,091	2,640,117	Interest coverage (x)	16.0	16.0	10.2	11.1	12.2
Liabilities						Net debt to equity	34.3%	34.9%	44.4%	47.7%	48.1%
Short-term loans	192,767	169,128	299,128	379,128	399,128	Sales/assets	1.0	1.0	0.6	0.6	0.7
Payables	383,004	364,060	174,554	178,203	181,004	Assets/equity	2.1	2.1	2.0	2.0	2.0
Others	69,718	46,641	46,641	46,641	46,641	ROE	11.8%	9.3%	4.9%	6.2%	6.3%
Total current liabilities	645,489	579,829	520,323	603,972	626,773	ROCE	8.4%	7.7%	4.2%	5.0%	4.9%
Long-term debt	302,862	370,301	351,786	351,786	386,965						
Other liabilities	123,824	137,562	137,562	137,562	137,562						
Total Liabilities	1,072,175	1,087,692	1,009,671	1,093,320	1,151,299						
Shareholder's equity	1,132,735	1,175,894	1,248,976	1,285,099	1,323,979						
BVPS (Rmb)	6.19	6.42	6.82	7.02	7.23						

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

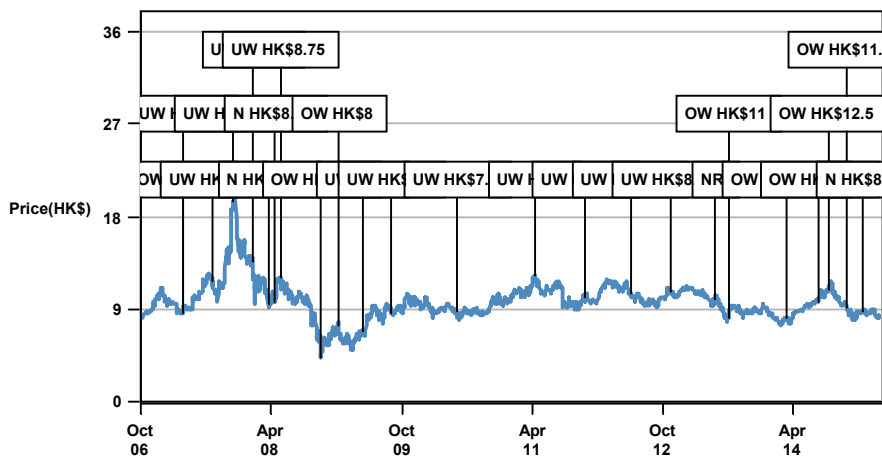
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PetroChina - H (0857.HK, 857 HK) Price Chart



Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends.
 Break in coverage May 08, 2013 - Jul 02, 2013.

Date	Rating	Share Price (HK\$)	Price Target (HK\$)
23-Mar-07	OW	8.66	7.40
30-Mar-07	UW	9.27	7.40
01-Aug-07	UW	11.66	8.30
23-Oct-07	UW	19.44	10.20
11-Jan-08	UW	13.68	12.00
19-Mar-08	N	9.60	10.50
19-Apr-08	N	9.82	8.75
06-May-08	UW	12.12	8.75
27-Oct-08	OW	4.25	8.75
08-Jan-09	OW	7.45	8.00
23-Apr-09	UW	6.79	6.00
18-Aug-09	UW	8.50	7.40
17-May-10	UW	8.76	7.60
06-Apr-11	UW	12.22	9.00
08-Nov-11	UW	10.08	8.50
13-May-12	UW	10.44	8.75
31-Oct-12	UW	10.80	8.25
08-May-13	NR	9.97	--
02-Jul-13	OW	8.25	11.00
03-Mar-14	OW	8.18	11.25
11-Jul-14	OW	9.80	11.80
28-Aug-14	OW	10.96	12.50
09-Nov-14	OW	9.18	11.50
18-Jan-15	N	8.72	8.20

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