BEA securities

EAST ASIA SECURITIES COMPANY LIMITED
9/F, 10 Des Voeux Road Central, Hong Kong.
Dealing: 3608 8000 Research: 3608 8097 Facsimile: 3608 6132

HONG KONG RESEARCH
16th September 2008

Analyst: Paul Sham

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$18.28 (12/09/2008)	Managing Director	: Mr. Alfred Chan Wing Kin
Shares Issued	: 6,665.6m		
Mkt. Cap.	: HK$121,847.2m	CFO	: Mr. John Ho Hon Ming
52 weeks Hi/ Lo	: HK$22.09 / HK$16.11		
HSI	: 19,352.90 (12/09/2008)		
Main Business	: Towngas supply		

SUMMARY OF THE INTERIM RESULTS FOR THE SIX MONTHS ENDED 30TH JUNE 2008

Interim Results Highlights

	1H2008 HK$ million	1H2007 HK$ million	*Change*
• Revenue	6,537.7	5,763.7	*+13.4%*
• Operating profit before returns on investments	2,020.7	2,097.0	*-3.6%*
• Other (Losses)/Gains, net	(113.3)	2,589.9*	*-104.4%*
• Interest expense	(128.7)	(167.4)	*-23.1%*
• Share of results of associates	772.0	689.6	*+11.9%*
• Share of results of jointly-controlled entities	281.6	710.2	*-60.3%*
• **Profit attributable to shareholders**	**2,524.3**	**5,469.9**	***-53.9%***
	HK¢	HK¢	
• EPS (HK¢)	37.9	82.1	*-53.8%*
• Operating EPS (HK¢)	30.4	29.5	*+3.1%*
• Interim DPS (HK¢)	12.0	12.0	*Unchanged*

** Mainly including a HK$2,235.7m one-off gain resulting from the acquisition of shares in Panva Gas Holdings Limited (Towngas China)*

- Hong Kong & China Gas ("HKG")'s 1H08 net profit fell 53.9% to HK$2,524.3m. Earnings decline was mainly due to the absence of the non-recurring one-off gains of HK$2,235.7m from the acquisition of Panva Gas (stock code: 1083) booked in 1H07.
- Stripping out non-recurrent gains from properties sales, IFC revaluation surplus and one-off gain from the Panva Gas acquisition, recurring profit attributable to shareholders was HK$2.03bn in 1H08, versus HK$1.96bn in 1H07, representing a 3.6% y-o-y growth.
- EPS was HK¢37.9 for 1H08 while recurring EPS was HK¢30.4. Meanwhile, the interim dividend remained unchanged at HK¢12 per share.
- As of 30 June 2008, HKG recorded net debts totalling HK$2,491.3m (31 Dec 2007: HK$2,939.5m). Its net debt-to-total equity ratio declined to 8.0% as of 30 June 2008 from 10.0% as of 31 Dec 2007.

This report has been prepared solely for information purposes and we are not soliciting any action based upon it. Neither this document nor its contents shall be construed as an offer, invitation, advertisement, inducement or representation of any kind or form whatsoever. The information is based upon information which we consider reliable, but accuracy or completeness is not guaranteed. Opinions expressed herein are subject to change without notice. At time of this report, East Asia Securities Company Limited has no position in securities of the company or companies mentioned herein, while its group companies may from time to time have interests in securities of the company or companies mentioned herein.

Business Review

	1H2008		1H2007		Change
Gas sales before fuel cost adjustment	*4,477.1*		*3,998.1*		*+12.0%*
Fuel cost adjustment	*977.5*		*527.9*		*+85.2%*
Gas sales after fuel cost adjustment	***5,454.6***	83.4%	**4,526.0**	78.5%	*+20.5%*
Equipment sales	493.4	7.5%	393.3	6.8%	*+25.5%*
Maintenance and services	139.6	2.1%	134.2	2.3%	*+4.0%*
Water sales	136.3	2.1%	120.1	2.1%	*+13.5%*
Property sales	8.1	0.1%	384.8	6.7%	*-97.9%*
Rental Income	11.4	0.2%	0.0	0.0%	*N/A*
Other sales	294.3	4.5%	205.3	3.6%	*+43.4%*
Total revenue	**6,537.7**	100.0%	**5,763.7**	100.0%	***+13.4%***

- Total revenue grew 13.4% y-o-y to HK$6,537.7m, mainly on stronger gas sales and equipment sales in mainland.

- With respect to its **Hong Kong business**, gas volume recorded 2% growth in 1H08 on 4% increase in residential gas sales, offset by 0.8% and 0.2% declines in commercial and industrial gas consumption respectively. Nevertheless, the freeze on gas tariffs and increase in operating expenses led to a 7.2% y-o-y decline in the contribution from the Hong Kong business, dropping from HK$1,647m in 1H07 to HK$1,529m in 1H08.

- Contribution from the **China gas business** was maintained at high growth of 57.6% y-o-y from HK$317m in 1H07 to HK$499m in 1H08, with the contribution to HKCG's recurrent earnings increasing from 16% in 1H07 to 25% in 1H08. The high earnings growth was driven mainly by a 43% y-o-y increase in gas sales volume, expanding from 2,113m^3 in 1H07 to 3,012m^3 in 1H08. Also, two development projects were set up in Auhui, Huangshan City and Liaoning Shenyang Jinhai Zone In 1H08, thus increasing HKG's city gas projects to 67.

- The 45.6%-owned Towngas China (1083.HK) turned around from a loss to a net profit of HK$101m in 1H08. Its turnover also increased by 51%, mainly due to organic growth, the new city gas project at Mingyang, Sichuan, and the new LPG operation in Wuhan.

- **Property income** dropped from HK$384m in 1H07 to only HK$8m in 1H08, as not many property units were sold in 1H08. There was around 4.4% of the Grand Water Front property development project and 4.0% of Grand Promenade property development project remain for sale at the end of June 2008. Management also admitted that the profits from property sales would reduce substantially for the whole of 2008 compared with 2007.

Outlook & Prospect

- ***Unexciting Hong Kong business*** HKG announced on 4th July, 2008 that it would raise the basic tariff by HK¢0.3 per MJ, an increase of approximately 1.4%, effective 1st October 2008. The tariff hike is mainly to offset rising costs faced by HKG and It would be the first basic gas price hike by HKCG since 1998. Despite this, we expects its gas sales volume growth in Hong Kong to be lacklustre given that the local market is mature with over 65% household penetration as well as little demand for industrial development.

- ***China growth story intact*** Given the saturated gas market in Hong Kong, HKG's long-term profit growth should be driven by its China gas business. HKG currently has 67 downstream gas distribution projects, including 35 owned by Towngas China. HKG expects gas sales volume growth of 33% to 6bn m^3 in 2008, but believes growth will slow down to 15-20% per annum in 2009-10 on limited new major gas infrastructure and gas supply. Management is still optimistic about its mainland business and expected HKG to make HK$900m net profit from its Chinese investment, including HK$499m in 1H08.

- ***HKG is further diversifying*** HKG intends to spend HK$8bn on new energy initiatives in the next three years. Management said six major scopes of activities for its ECO unit include 1) coal-bed methane exploration/liquefaction, 2) coal mine methane liquefaction, 3) coal-based to fuels/chemical material, 4) automobile fuels to replace petroleum, 5) bio-fuel Gas Utilities production, and 6) research on clean fuel applications. Even though these projects are still far from contributing sizable income to HKG, they provide HKG new income sources, especially in the upstream projects.

- ***Valuation*** Given the flat gas demand growth in Hong Kong and the keen competition from the two power companies, especially after the new Schemes of Control take effect, the growth potential of HKG will mainly depend on China's growth potential going forward. At HK$18.28, HKG trades at 28.7x FY08E P/E and offers a modest 1.9% dividend yield, the lowest among the 3 main utility stocks. Therefore, we believe HKG is trading at a high premium, which overly reflects the market's expectation for HKG's growth potential in China. We therefore prefer other utilities counters like CLP or HKE for better yield.

Recommendation: ***Prefer other utilities counters like CLP or HKE for better yield***

Important Disclosure / Analyst Certification / Disclaimer

This document is published by East Asia Securities Company Limited, a wholly-owned subsidiary of The Bank of East Asia, Limited (BEA).

The research analyst primarily responsible for the content of this report, in part or in whole certifies that the views on the companies and their securities mentioned in this report accurately reflect his/her personal views. The analyst also certifies that no part of his/her compensation was, is, or will be, directly, or indirectly, related to specific recommendations or views expressed in this report.

This report has been prepared solely for information purposes and has no intention whatsoever to solicit any action based upon it. Neither this report nor its contents shall be construed as an offer, invitation, advertisement, inducement or representation of any kind or form whatsoever. The information is based upon information, which East Asia Securities Company Limited considers reliable, but accuracy or completeness is not guaranteed. Information and opinions expressed herein reflect a judgment as of the date of this document and are subject to change without notice. Any recommendation contained in this report does not have regard to the specific investment objectives, financial situation and the particular needs of any specific addressee. This report is not to be taken in substitution for the exercise of judgment by respective readers of this report, who should obtain separate legal or financial advice. East Asia Securities Company Limited and / or The BEA Group accepts no liability whatsoever for any direct or consequential loss arising from any use of this report or further communication given in relation to this report.

At time of this report, East Asia Securities Company Limited has no position in securities of the company or companies mentioned herein the report, while BEA along with its affiliates and/or persons associated with any of them may from time to time have interests in the securities mentioned in this report. BEA and its associates, its directors, and/or employees may have positions in, and may effect transactions in securities mentioned herein and may also perform or seek to perform broking, investment banking and other banking services for these companies.

BEA and/or any of its affiliates may beneficially own a total of 1% or more of any class of common equity securities of the subject company or companies mentioned in this report and may, within the past 12 months, have received compensation and/or within the next 3 months seek to obtain compensation for investment banking services from the subject company or companies mentioned in the report.

This document is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of, or located in, any locality, state, country or other jurisdiction, publication, availability or use would be contrary to law and regulation.