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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
HKSE Code	:	0003
Market Price	:	HK$21.85 (26/03/2008)
Shares Issued	:	6,059.6m
Mkt. Cap.	:	HK$134,402.3m
52 weeks Hi/ Lo	:	HK$24.30 / HK$16.00
HSI	:	22,617.01 (26/03/2008)
Main Business	:	Towngas supply

Chairman	:	Dr. Lee Shau Kee
Managing Director	:	Mr. Alfred Chan Wing Kin
CFO	:	Mr. John Ho Hon Ming

SUMMARY OF THE FINAL RESULTS FOR THE YEAR ENDED 31ST DECEMBER 2007

Final Results Highlights

	FY2007 HK$ million	FY2006 HK$ million	*Change*
• Revenue	14,225.5	13,465.3	*+5.6%*
• Operating profit before returns on investments	5,303.0	5,169.1	*+2.6%*
• Investment income	364.3	527.2	*-30.9%*
• Other gains	2,258.4	0.0	*NA*
• Interest expense	(364.0)	(310.2)	*+17.3%*
• Share of results of associates	1,130.0	316.1	*+257.5%*
• Share of results of jointly-controlled entities	1,616.3	1,102.0	*+46.7%*
• **Profit attributable to shareholders**	**9,269.6**	**5,862.6**	***+58.1%***
• EPS	1.530	0.967	*+58.2%*
• Final DPS	0.23	0.23	*+0.0%*
• Total DPS	0.35	0.35	*+0.0%*

- Hong Kong & China Gas ("HKG") reported a 58.1% increase in net profit to HK$9,269.6m for FY07, beating market consensus of HK$7,918.7m. Excluding non-cash gain from Panva Gas deal, property sales and property revaluation gain, recurring net profit was up only 3.2% to HK$3,215.8m, on a higher contribution from its Mainland operations.

- In 2007, HKG recorded several non-recurring items which boosted the overall net profit, including: 1) Acquisition of shares in Panva Gas Holdings Limited by way of asset injection, amounting to HK$2,235.7m; 2) Sales of properties in Grand Waterfront, Grand Promenade and King's Park Hill, amounting to HK$2,775.0M; 3) Revaluation surplus from investment properties, amounting to HK$1,460.4m.

- EPS was HK$1.53 for FY07 while recurring EPS was HK$0.53. Meanwhile, final DPS was maintained at HK$0.23 and the full-year dividend payout ratio for FY07 was 22.9% (FY06: 36.9%). HKG also proposed a 1 for 10 bonus issue.

- As of 31/12/2007, HKG recorded net debts totalling HK$2,940.3m (31/12/2006: HK$6,415.8m). Its net debt-to-total equity ratio declined remarkably to 10.0% as of 31/12/2007 from 30.2% as of 31/12/2006.

Business Review

	FY2007		FY2006		*Change*
Gas sales before fuel cost adjustment	7,524.0		6,988.9		
Fuel cost adjustment	1,021.5		1,359.4		
Gas sales after fuel cost adjustment	***8,545.5***	*60.1%*	***8,348.3***	*62.0%*	*+2.4%*
Equipment sales	770.1	*5.4%*	784.8	*5.8%*	*-1.9%*
Maintenance and services	272.1	*1.9%*	255.9	*1.9%*	*+6.3%*
Water sales	260.9	*1.8%*	209.6	*1.6%*	*+24.5%*
Property sales	3,806.3	*26.8%*	3,366.5	*25.0%*	*+13.1%*
Rental Income	9.6	*0.1%*	0.0	*0.0%*	*NA*
Other sales	561.0	*3.9%*	500.2	*3.7%*	*+12.2%*
Total revenue	**14,225.5**	*100.0%*	**13,465.3**	*100.0%*	***+5.6%***
Total revenue (ex-Property related income)	**10,409.6**		**10,098.8**		***+3.1%***

- Total revenue amounted to HK$14,225.5m, up 5.6%, while total recurring revenue (ex-Property related income) was up 3.1% to HK$10,409.6m, on higher gas sales and water sales in China.

- In Hong Kong, gas sales was flat, with Towngas volume sales increased at a meagre of 0.03% to 27,041.0m MJ. The volume of commercial and industrial gas sales increased by 2.1% y-o-y due to the thriving hotel and restaurant sectors, but was offset by the residential gas sales which decreased by 1.6% y-o-y, due to keen competition in the energy sector. Number of customers increased by 1.5% to 1.646m.

- Net profit contribution from Mainland operations was up 82.8% to HK$664.6m (or 20.7% of HKG's recurring earnings ex-Property sales). Gas volume sales from piped city-gas projects in the Mainland jumped 114.9% to 4,555m m^3, while customer base also rose 95% to 8.2m. Revenue from HKG's water projects (Wujiang in Jiangsu province, Wuhu in Anhui province and Suzhou Industrial Park in Jiangsu province) increased 24.4% y-o-y to HK$260.9m.

- HKG recorded property sales of HK$2,775m from the sale of the residential units at Grand Waterfront in Ma Tau Kok (HKG owns 73% interest) and its share of profits amounted to HK$866.3m. The sales of Grand Promenade (HKG owns 50% interest) in Sai Wan Ho also generated HK$1,829m in profit. Revaluation gain of HK$1,269.4m was being booked re. its 15.8% owned International Finance Centre.

Outlook & Prospect

- ***Unexciting Hong Kong business*** Stagnant earnings growth in the Hong Kong Towngas business is expected as the sales volume growth remains flat for the past few years. Earnings growth in HK may only materialize with a tariff hike, which has not been announced yet. Furthermore, property sales from Grand Promenade and Grand Waterfront can provide little help in cash flow as the cumulative GFA sold from these two projects have reached 95.9% and 95.8% respectively.

- ***Mainland earnings momentum should sustain*** Profit contribution from the Mainland increased at a CAGR of 90.3% from HK$14m in 2001 to HK$664.6m in 2007, and represented 20.7% of HKG's total profit in FY08. Earnings growth from China remains the key earnings driver for HKG.

- ***New business line in clean energy*** Since 2008, HKG has stepped up its interest into clean energy businesses in both Hong Kong and China. Projects in HK include LPG filling stations, landfill gas project and an aviation fuel facility while projects in China include methanol projects and coalbed gas liquefaction joint venture. Even though these projects are still far from contributing sizable income to HKG, they provide future growth prospects to the company, just like its investment in China few years ago which now provides more than 20% of total earnings.

- ***Rich valuation not justified*** HKG is currently trading at 14.3x FY07 P/E. However, if we strip out all the non-recurring items, including property sales which is unlikely to repeat in 2008, valuation of HKG would reach 40x, which is very demanding when compared with other two blue-chip HK utility plays CLP and Hongkong Electric, whose FY07 P/Es are at mid-teen only. Even assuming that the current momentum of 90% growth in China can be maintained, the incremental earnings increase will not be able to offset the loss of earnings from property. Therefore, we believe its China growth potential is overly reflected in the share price. In addition, its dividend yield of 1.6% is the lowest among the 3 main utility stocks. We therefore recommend investors to “Sell” the counter.

Recommendation: ***Sell***

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