

Analyst: Vincent Leung
THE HONG KONG AND CHINA GAS COMPANY LIMITED (中華煤氣)

Sector	: Utilities	Chairman	: Dr. Lee Shau Kee
HKSE Code	: 0003	Managing Director	: Mr. Alfred Chan Wing Kin
Market Price	: HK\$18.32 (13/09/2007)	CFO	: Mr. John Ho Hon Ming
Shares Issued	: 6,059.636 million		
Mkt. Cap.	: HK\$111,012.5 million		
52 weeks Hi/ Lo	: HK\$19.180 / HK\$14.964		
HSI	: 24,537.02 (13/09/2007)		
Main Business	: Towngas supply		

SUMMARY OF THE INTERIM RESULTS FOR THE SIX MONTHS ENDED 30TH JUNE 2007
Interim Results Highlights

	1H2007	1H2006	Change
	HK\$ million	HK\$ million	
• Total revenue	5,763.7	5,418.4	+6.4%
• Operating profit before returns on investments	2,097.0	1,969.8	+6.5%
• Investment income	354.2	182.8	+93.8%
• Interest expense	(167.4)	(146.2)	+14.5%
• Gain on disposal of interests in subsidiaries	2,235.7	-	N/A
• Share of results of associates	689.6	714.5	-3.5%
• Share of results of jointly-controlled entities	710.2	168.0	+322.7%
• Profit attributable to shareholders*	5,469.9	2,509.5	+118.0%
	HK¢	HK¢	
• EPS*	90.3	^41.4	+118.1%
• Recurring EPS	32.4	^29.8	+8.7%
• Interim DPS	12.0	12.0	unchanged

*Includes share of profits from sale of properties of HK\$728.2 million (1H2006: HK\$117.7 million) and revaluation surplus of an investment property of HK\$542.2 million (1H2006: HK\$588.2 million); ^ Adjusted for a bonus issue (1 bonus share for every 10 shares held) in 2007.

- Hong Kong & China Gas ("HKG") reported a 118.0% y-o-y jump in net profit to HK\$5,469.9 million for 1H2007, which was above market consensus of HK\$4,996 million. Excluding property sales, property revaluation gain and gain on disposal of interests in subsidiaries, recurring net profit was up 8.9% y-o-y to HK\$1,963.8 million, driven by higher contributions from its mainland operations.
- During 1H2007, HKG recorded profits from property sales of HK\$728.2 million, reflecting the pre-sale of the residential units at Grand Waterfront in Ma Tau Kok (HK\$170.7 million) as well as the inventory sales of Grand Promenade in Sai Wan Ho (HK\$547.2 million) and King's Park Hill (HK\$10.3 million) in Ho Man Tin. In addition, HKG recorded revaluation gain of HK\$542.2 million in 1H2007 from its 15.8%-owned International Finance Centre (1H2006: HK\$588.2 million). HKG also recorded a one-off gain of HK\$2,235.7 million from the injection of 10 mainland piped city-gas JVs into Towngas China (stock code: 1083) that was completed on 1st March 2007.
- EPS was HK¢90.3 for 1H2007 while recurring EPS was HK¢32.4. Meanwhile, interim DPS was maintained at HK¢12.
- As of 30/06/2007, HKG recorded net debts totalling HK\$3,203.0 million (31/12/2006: HK\$6,415.8 million). Its net debt-to-total equity ratio declined to 12.5% as of 30/06/2007 from 30.2% as of 31/12/2006. Management said HKG's gearing ratio will not go beyond 35%.

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Business Review

	1H2007		1H2006		Change
Gas sales before fuel cost adjustment	3,998.1		3,757.2		+6.4%
Fuel cost adjustment	527.9		830.4		-36.4%
Gas sales after fuel cost adjustment	4,526.0	78.5%	4,587.6	84.7%	-1.3%
Equipment sales	393.3	6.8%	374.2	6.9%	+5.1%
Maintenance and services	134.2	2.3%	128.0	2.4%	+4.8%
Water sales	120.1	2.1%	90.5	1.7%	+32.7%
Property sales	384.8	6.7%	-	-	N/A
Other sales	205.3	3.6%	238.1	4.4%	-13.8%
Total revenue	5,763.7	100.0%	5,418.4	100.0%	+6.4%
Total recurring revenue (ex-Property sales)	5,378.9		5,418.4		-0.7%

- Total revenue grew 6.4% y-o-y to HK\$5,763.7 million, while total recurring revenue (ex-Property sales) edged down 0.7% y-o-y to HK\$5,378.9 million.
- In Hong Kong, gas sales was stagnant, with Towngas volume sales edging up 0.2% y-o-y to 15,020 million MJ, as a 3.2% increase in gas sales to the commercial & industrial sector were more than offset by a 1.9% drop in sales to residential segment amid higher temperatures during 1H2007. Number of customers increased by 1.5% y-o-y to 1.63 million.
- Profit contribution from mainland operations (including both city piped-gas & water JV projects and contribution from 43.9%-owned Towngas China) surged 68% y-o-y to HK\$317 million (or 16% of HKG's recurring earnings), which included ~HK\$280 million from HKG's own projects and a ~HK\$33-million contribution from Towngas China (acquisition completed on 1st March 2007). Including those of Towngas China, gas volume sales from the 60 city piped-gas JV projects jumped 129% y-o-y (40% organic & 89% acquisitions) to 2,113 million m³, while customer base rose 47% y-o-y, or 4.66 million (0.47 million organic & 4.19 million acquisitions), to 7.9 million.
- HKG's 43.9%-held Towngas China reported a net profit of HK\$50.5 million for 1H2007, compared with a net loss of HK\$221.1 million a year earlier resulting from the loss in fair value of derivatives of HK\$181.6 million and the net interest expense of HK\$461.1 million incurred on the interest rate swaps. A 10.8x surge in contribution from associates to HK\$49.9 million, and the additional contribution of HK\$30.3 million from the 6 piped-city gas JVs acquired from HKG were also the major driver for Towngas China's 1H2007 net profit. Basic EPS was HK¢3.35 and no interim dividend was declared. On 23rd August 2007, S&P raised its long-term corporate credit rating on Towngas China from "BB+" to "BBB-" and the outlook is stable, reflecting strengthening financial profile after HKG became the major shareholder of the company. HKG's management said Towngas China recorded a net profit of ~HK\$70 million during March-June 2007 and a net loss of ~HK\$20 million during January-February 2007.
- HKG recorded property sales of HK\$384.8 million for its 73% share from the pre-sale of the residential units at Grand Waterfront in Ma Tau Kok, with ~57% of the residential GFA already sold by the end of 1H2007, and its share of profits amounted to HK\$170.7 million. Meanwhile, inventory sales of Grand Promenade in Sai Wan Ho generated HK\$547.2 million in profit (1H2006: HK\$74.1 million) for HKG's 50% interest in the project, of which ~10.6% of the total residential GFA remained unsold.



Outlook & Prospect

- **Stable Hong Kong business** Although the stagnant growth for Towngas demand in Hong Kong is expected to see only low single digit growth, the stable monopoly business, which is not subject to regulatory risks that CLP (stock code: 0002) and Hongkong Electric (stock code: 0006) are facing, is the cash generator to fund the more exciting mainland expansion.
- **China growth story intact** Mainland business should remain the only exciting story for HKG, with profit contribution increasing to 16% of HKG's recurring net profit. HKG expects to conclude 6 new gas/water JVs per year in the coming years and has planned total investment of HK\$10.0 billion in the mainland over the next 3 years. HKG's management expects its mainland operations, which include downstream piped city-gas & water JVs, midstream gas distribution pipelines as well as upstream natural gas exploration & coal-bed methane projects, to make 18%-20% contribution to HKG's total recurring earnings in 3 years.
- **Valuation** Trading at 17.8x FY2007E P/E, valuation of HKG looks rich when compared with other two blue-chip Hong Kong utility plays CLP (11.9x FY2007E P/E) and Hongkong Electric (11.9x FY2007E P/E). The premium valuation should be justified with HKG's stable cash-generating Hong Kong Towngas business and its positive China growth potential. HKG's shares (+15.2%) have underperformed the HSI (+22.9%) year-to-date amid lingering concerns over the city-gas business in China (i.e. scrapping of connection fees in Guangdong province) and slowing growth in the core Hong Kong gas business (as well as non-core property development earnings). We see such underperformance a good buying opportunity for investors and the share purchase by HKG's chairman and Henderson Investment (stock code: 0097) should provide support to the premium valuation. We therefore recommend investors to "Accumulate" the stock.

Recommendation: *Accumulate*



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