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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$14.06 (22/03/2016)	Managing Director	: Mr. Chan Alfred Wing Kin
Shares Issued	: 11,561m		
Mkt. Cap.	: HK$162,548m	CFO	: Mr. Ho John Hon Ming
52 weeks Hi/ Lo	: HK$17.06 / HK$13.12		
HSI	: 20,666.75 (22/03/2016)		
Main Business	: Gas supply		

SUMMARY OF THE FINAL RESULTS FOR THE YEAR ENDED 31ST DECEMBER 2015

Final Results Highlights

	FY2015 HK$ million	FY2014 HK$ million	Change
♦ Revenue	29,591	31,615	*-6.4%*
♦ **Profit attributable to shareholders**	**7,302**	**6,960**	***+4.9%***
HK Gas business	*2,719*	*2,690*	*+1.1%*
Mainland Utilities	*3,500*	*3,430*	*+2.0%*
New Energy	*312*	*510*	*-38.8%*
Financial items	*771*	*330*	*+133.6%*
♦ EPS	0.632	0.615	*+2.8%*
♦ 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$7,302m in FY15, up 4.9% y-o-y. The reported earnings were lower than the consensus estimates of HK$7,434m, attributable to the sharp earnings decline from its new energy and weaker-than-expected gas sales from its Mainland utilities business. Excluding non-core financial items, earnings from energy businesses fell 1.5% y-o-y to HK$6,531m.
- Despite higher net profit, Management maintained the final dividend at HK$0.23 for FY15. Together with the interim dividend of HK$0.12, total dividend per share amounted to HK$0.35, representing a dividend payout ratio of 55.4% (FY14: 56.9%). Similar to the previous few years, HKCG declared one bonus share for every 10 shares.
- As of 31st December 2015, HKCG recorded net debts totalling HK$19,823m (31st December 2014: HK$18,378m), leaving its net debt-to-total equity ratio of 31.9%, up from 29.5% a year ago.

Business Review

- Net profit of **Hong Kong gas business** increased 1.1% y-o-y to HK$2,719m, driven by a 4.4% hike in basic tariff effective 1st August 2015. Nevertheless, growth in Hong Kong gas sales volume was sluggish in 2015, down 1.5% y-o-y to 28,404 million MJ (megajoule), impacted by less gas demand in hotel sector amid fewer inbound tourists during 2015. In addition, residential gas sales were also affected by record high temperature in winter. As at the end of 2015, the number of customers was 1,839,261, an increase of 19,326 compared to 2014, slightly up by 1.1%.
- Net profit from **Mainland utilities**, including the contribution from Towngas China (01083.HK, 60.77%-owned subsidiary of HKCG) was HK$3,500m, up 2.0% y-o-y. The total volume of gas sales in 2015 was approximately 15.5 billion cubic metres, a slight increase of 2% over 2014, much slower than the double-digit growth in the previous years. The decelerating growth in gas sales volume was driven by (i) warmer than usual winter months during 4Q15 and (ii) delayed downward adjustment in natural gas price (only had the adjustment made in November 2015), which led to less demand on natural gas compared to other fuels such as diesel or LNG/LPG.
- Net profit from **New Energy** dropped 38.8% y-o-y to HK$312m. The sharp fall in earnings was attributable to lower oil prices, resulting in only HK$77m (-47% y-o-y) of earnings from the Thailand oil E&P business. Performance of HK aviation fuel business was steady in 2015, with its income up 6% y-o-y to HK$289m. Other projects in China were either largely breakeven (such as the liquefied coal-bed-methane project in Shanxi) or loss making (such as the coal mines).

Outlook & Prospect

- ***Gas sales rebound in Mainland utilities business*** HKCG’s gas volume growth of 2% y-o-y in Mainland utilities business was a disappointment as it was far below Management’s previous guidance of “high single digit” growth. Despite the weak gas sales in FY15, gas sales started to recover and rebounded to 12% y-o-y growth in 1Q16, thanks to the 28% gas price cut in November 2015. Management expects gas sales volume to grow over 10% y-o-y in 2016. Management said another round of gas price cuts later this year could still be possible. In general, Management expects China’s gas business to deliver high-single-digit earnings growth in the next five years.
- ***New energy business dragged by oil prices*** New Energy is the riskiest yet fastest-growing segment among HKCG’s operations. Since the oil prices peaked off in 2014, HKCG’s New Energy segment performed poorly as margins of HKCG's oil business in Thailand and PRC coal mining business were squeezed. Management revealed the Thailand project could only break-even with an oil price of US$28/barrel. Looking forward, HKCG is diverting away from projects with high exposure to oil prices going forward, including the Jiangsu Xuzhou coke-oven-gas (COG) to LNG plant in 2H16, and projects to convert agricultural waste into high-grade chemicals. Nevertheless, unless oil price rebounds notably in 2016, New Energy segment is expected to deliver similar earnings in 2016, as there should be minimal profit contribution from new projects to be commissioned in late 2016.
- ***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-2015. Following the tariff hike in August 2015, HKCG will likely maintain the current tariff until 2017 or 2018 as HKCG historically increases its basic tariff every two or three years. Therefore, Hong Kong gas business is likely to remain at low single-digit growth in 2016. 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.
- ***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 2016E P/E of 21.6x far exceeds peer averages of China gas utilities (12x) and Hong Kong utilities (18x). 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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