# Xinao Gas 新奥(2688)

Company update

**BUY**

3 July 2006

## A steady growth

Analyst: Nikita Zhang
Nikita.zhang@firstshanghai.com.hk
Tel: (852) 2532-1915

| | |
|---|---|
| Industry | Natural gas distribution |
| Price | HK$ 7.40 |
| Target price | HK$ 8.50 (+15%) |
| Old target price | HK$ 9.00 |
| Stock code | 2688 |
| H-shr Market cap. | HK$6,842mn |
| H-share O/S | 924.56mn |
| 52wk high/low | HK$ 8.1/5.35 |
| NAV per share | HK$2.58 |
| Major shareholder | Wang Yusuo(36.98%) |

➢**Entering a steady growth stage**. Xinao is now entering into an organic growth stage. We expect Xinao's top line to grow at a 37% Cagr in 05-08E. We adjusted our forecast of Xinao's new household connections growth to average 30% yoy from our old forecast of 40% after factoring in the negative impact of mainland's prevailing tightening measures on China property developments as 70% of Xinao's annual new connections are coming from new property projects.

➢**Shifting into recurring piped gas sales**. Xinao's revenue relies more and more on recurring piped gas sales, a healthy revenue model. C&I users in fast-growing cities continue to shore up strong demand for natural gas. We expect Xinao to deliver average 50% yoy growth in its gas sales volume, with gas sold to C&I users accounting for over 65% during 06-08E. As such, the piped gas sales will likely contribute to its total revenue from 37% in 05 to 66% in 08E. Although its overall gross margin will be decreasing, we expect it stands stable at 33%-35% during 06-08E.

➢**Concern over gas pricing issue in the mid term is unnecessary.** Currently China's city gas retail prices are set 30%-40% below international levels. The market is concerned on city gas operators' ability to pass extra gas cost on to customers under the pricing reform towards a free market. In our view, in the mid term (before 2015) the concern is not necessary as LNG terminals in China scaled back after supply hits hurdles. We believe Xinao will not be vulnerable to a temporary margin squeeze given less than 0.1% of that expected after 06 due to some projects not granted automatic cost pass-through.

➢**15% room up**. We expect 80% CB to be converted into ordinary shares in 06 and 100% in 07. Higher expected dividend payout expected in 06 and 07 should offset EPS dilution effect. We have downgraded our target price to HK$8.50 based on our end-06 DCF to reflect our cut in new connections and higher US interest rate expected at the end of 06. Its interest swap adds additional volatility to the net profit, but fair value loss on derivation, a non cash flow item in the P&L, doesn't have any impact on our DCF valuation model.

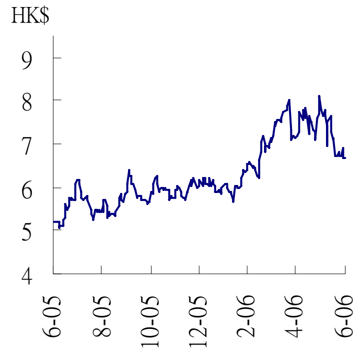
HK$=RMB1.03

### Earning Summary

| Year-end 31 Dec | 04A | 05A | 06E | 07E | 08E |
|---|---|---|---|---|---|
| Turnover (Rmb m) | 1,440 | 2,057 | 2,932 | 4,001 | 5,264 |
| Growth (%) | 64% | 43% | 43% | 36% | 32% |
| Net Profit (Rmb m) | 252 | 303 | 375 | 433 | 534 |
| Growth (%) | 38% | 20% | 24% | 15% | 23% |
| Diluted EPS (Rmb) | 0.29 | 0.32 | 0.40 | 0.44 | 0.54 |
| Growth (%) | 19% | 10% | 23% | 10% | 23% |
| PER (x) | 26 | 24 | 19 | 17 | 14 |
| DPS (Rmb) | 0.03 | 0.05 | 0.08 | 0.11 | 0.16 |
| Yield (%) | 0.4% | 0.6% | 1.1% | 1.4% | 2.1% |

Source: company information, FSSL

### Price Performance




Source: Bloomberg

# Steady growth stage

*Penetration stage, targeting at 35% penetration rate by 09*

Xinao is entering into a stage of steady growth as it shifts its business strategy from acquisition to organic expansion, aiming at an overall penetration rate of 35% by 09. The increased focus on existing cities by scaling back from 6-7 new city projects to 1-2 big cities per year will boost its new connections and gas sales incomes. In 05, its new connection grew at 34% yoy, while its gas volume was up 90%. We expect its strong gas volume growth to continue given that its more and more cities are accessible to piped gas sources.

The mainland's prevailing macro measures are set to slow down the pace of new property development, which provides a key source for city gas operators to grow new connections. We therefore lowered our forecast of Xinao's new household connections growth to average 30% yoy from 40% as 70% of its yearly new connections are from new property projects.

*A pragmatic business model*

We think Xinao is taking a pragmatic and correct approach, since: 1) currently there are limited numbers of available high quality cities. According to China Gas (384) and Xinao, there are only around 16 high quality cities not yet taken up by city gas operators. A high quality city means a big and fast-growing one with over 1m population, which currently has no pipeline infrastructure and will have piped natural gas sources in 2-3 years. Operation in high quality cities offers the highest return as connection fees incomes proves a key earning driver to operators when cities begin to develop gas distribution system; 2) acquisition prices are too high due to fierce competition in China's city gas market; 3) Xinao has limited management resources to manage operations in over 63 cities.

**Table 1: Assumptions on Xinao's new connections**

| | 04A | 05A | 06E | 07E | 08E |
|---|---|---|---|---|---|
| ***Residential households new connections*** | | | | | |
| Old forecast | 253,395 | 334,637 | 557,606 | 683,673 | 834,246 |
| New forecast | 253,395 | 334,637 | 450,000 | 585,000 | 760,500 |
| Total connected households | 950,795 | 1,793,216 | 2,320,867 | 3,284,027 | 3,588,716 |
| Total connectable households | 9,709,333 | 10,662,000 | 11,604,333 | 11,728,667 | 12,195,333 |
| Population coverage | 29,128,000 | 31,986,000 | 33,586,000 | 35,186,000 | 36,586,000 |
| Penetration rate | 10% | 17% | 20% | 26% | 29% |
| ***C&I installed designed daily capacity( $m^3$)*** | 1,250,873 | 2,495,479 | 3,995,479 | 5,495,479 | 6,995,479 |

Source: company information, FSSL estimates

## Highly competitive in acquisition of high quality projects

*No.1 ranking in China city gas market*

The current China city gas market is facing intensive competition and high entry barriers. With more and more players, some of which being subsidiaries of top oil & gas giants, rushing into natural gas downstream, the competition is getting intensified, which sends the acquisition prices to soar.

Compared to its peers, Xinao is highly competitive in winning quality cities especially big ones with population over 1 million. Its advantage stems from: 1) its strong track record for over 10 years; 2) strong fund resources; 3) strong professional management team; and 4) stable natural gas sources. In bidding concession rights of operating in high quality cities, Xinao is competing with only a handful of rivals, e.g. Hong Kong & China Gas. But key rivals such as China Gas and Panva Gas (1083) are dwarfed as they do not have track records of operation in high quality cites.

*Target only at quality cities*

Xinao targets cities in fast-developing provinces such as Guangdong, Guangxi, Fujian and Zhejiang. We notice Xinao's apparent strength in Guangdong and Guangxi as Xinao controls natural gas sources through its own Weizhou Island LNG facilities in Guangxi province. We also see Xinao's advantage in large cities as their operations normally require the bidder to have 10 years' track record.

### Stringent standard for new projects leads higher ROE

*IRR of 15%*

Xinao sets strict standards for new acquisitions. It targets booming quality cities with fast-growing economy, well-developed industries and large populations. Xinao invests only in projects meeting its stringent required return of 15% IRR. In comparison, its peer China Gas demands 13% ROE, Panva Gas requires the acquisition price of less than 10PE and Hong Kong & China Gas accepts high acquisition prices 2-3 times of net acquired asset. We believe that the stringent standards minimize the investment risk and enable Xinao to deliver ROE much higher than its peers.

### Adopting a successful development model

Xinao emphasizes strategic development of its project cities. In 05, Xinao built up a successful business model based on the experience drawn from Fengyang project by expanding from a core project to periphery cities and towns. Early this year Xinao adopted the successful development model by acquiring 3 new cities with total urban population 626,000 in Fujian province. This development model enables Xinao to maximize resources value by fully utilizing them at low costs.

# Powering ahead

## Shifting into recurring gas sales, stable gross margins

*20% stable EBITDA margin expected from 09 onwards*

As Xinao shifts to rely more on recurring piped gas sales, its revenues become more stable and healthy. But the overall margin pressure will continue due to changes in revenue mix. We expect its overall margin to decrease, but keep stable gross margin of 33%-35% during 06-08E, EBITDA margin to decline to 20% by 09 and to stabilize at this level in future.

*50% yoy gas volume growth to be expected*

C&I users shall continue to underpin strong demand for natural gas. We expect gas volume sold to C&I users to grow at a Cagr 60% (same as our old forecast). New connections tend to be very seasonal with over 50% new connections occurring in the fourth quarter every year and 70% of them on new property developments. It takes several years for each household in new properties to consume an average 18-25$m^3$ per month, the average volume a resident in old buildings consumes. We expect the gas volume sold to C&I users from 06 onwards will account for over 65% of the total gas volume sold, which can grow at 50% yoy during 06-08E. Hence we expect its piped gas sales to contribute to the total revenue from 37% in FY05 to 49%, 59% and 66% in 06E, 07E and 08E respectively, signaling a shift to recurring piped gas sales as revenue source.

*Stable gross margins*

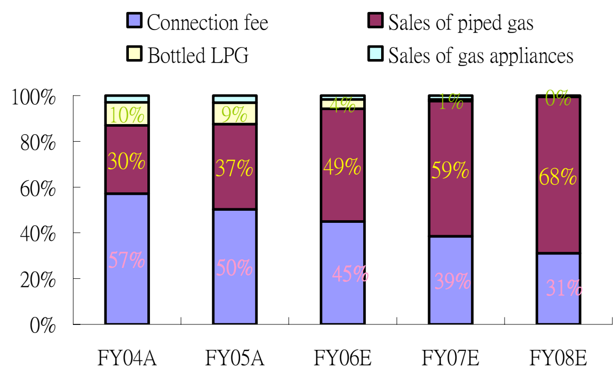
While Xinao will be offering steep discounts on connection fees to industrial/commercial customers to promote natural gas consumption. We believe connection fee for residential customers will remain stable. We expect stable piped gas sales margin at 25-30% in future and overall connection fee gross margin at 65%-70% during 06-08E.

Although it is very unlikely for China to remove connection fee charge before 2008, we believe that city gas operators risk losing connection fees income in future as cities will gradually open up their gas market and cancel the connection fees. Xinao is less vulnerable to the policy change than its peers such as China Gas and Panva Gas.

**Table 2: Xinao's average connection fee**

| | 04A | 05A | 06E | 07E | 08E |
|---|---|---|---|---|---|
| ***Residential households (Rmb/household)*** | | | | | |
| Old forecast | 2,620 | 2,672 | 2,540 | 2,491 | 2,466 |
| New forecast | 2,620 | 2,672 | 2,647 | 2,580 | 2,300 |
| ***C&I users (Rmb/ m3 of capacity)*** | | | | | |
| Old forecast | 302 | 268 | 273 | 258 | 246 |
| New forecast | 302 | 268 | 200 | 150 | 120 |

**Figure 1: Xinao's revenue mix**




Source: company information, FSSL estimates

**Table 3: Revenue mix breakdown: peer comparison**

| ***% of Revenue Mix*** | 04A | 05A | 06E | 07E | 08E |
|---|---|---|---|---|---|
| **Connection fee** | | | | | |
| ***Xinao Gas*** | ***60*** | ***50*** | ***45*** | ***38*** | ***31*** |
| China Gas | 49 | 71 | 56 | 47 | 46 |
| Panva Gas | 24 | 31 | 34 | 36 | 37 |
| **Piped gas sales** | | | | | |
| ***Xinao Gas*** | ***30*** | ***37*** | ***49*** | ***59*** | ***68*** |
| China Gas | 13 | 25 | 42 | 52 | 53 |
| Panva Gas | 4 | 7 | 9 | 12 | 16 |
| **LPG and others** | | | | | |
| ***Xinao Gas*** | ***10*** | ***3*** | ***6*** | ***3*** | ***1*** |
| China Gas | 8 | 4 | 2 | 1 | 1 |
| Panva Gas | 72 | 62 | 57 | 52 | 47 |

Source: company information, FSSL estimates

## Concerns over gas pricing issue in the mid term is unnecessary

*We expect LNG to be imported at international*

Imported LNG (liquefied natural gas) will play an increasingly important role in China in future. For the 3rd LNG terminal, which was proposed for construction in 08 and *prices from 2010*

operation in 2010, LNG will be imported at international price levels.

*China new pricing policy aims to narrow the price gas between domestic and international*

China's natural gas wholesale prices were artificially low. The new gas pricing policy announced in Dec 05 aims to gradually increase domestic natural gas wholesale price to a more market-oriented level, narrowing the gap between domestic and international prices and encouraging upstream gas producers to increase output. Under the new pricing mechanism, natural gas is still cost competitive in terms of price/heat among all alternative energies except coal. But currently China's city gas retail prices are still 30%-40% below international levels. It takes 4- 5 years for China's domestic price to be aligned with the current international price levels. Under the government's pricing policy, the gas price will be adjusted upwards once a year at about 4-8% each time. In 4-5 years time, China's city gas users will face more than 40% price increase.

*China's LNG terminals construction slows down*

The market is concerned on city gas operators' ability to pass extra gas cost on to customers all the time. In our view, the concern is unnecessary in the mid term (before 2015) as LNG terminals in China scaled back after supply hits hurdles. The Asian LNG supplies suddenly look tight as US west coast has entered the fray to compete with the world's largest LNG importers from Japan and Korea. At the moment, China is reluctant to pay double the price of CNOOC's 2002 deal (China's first LNG terminal in Guangdong), so attempts to buy additional LNG for its 3rd LNG terminal may fail. The tight natural gas supply in the world especially in Asia will definitely send LNG prices higher in future.

Power plants and city gas operators are two main LNG users in coastal cities. With coal offering a cheaper alternative, the difference in costs has forced power suppliers to consider coal as a fuel choice. Datang Power (991) has not shown any interest in using imported LNG at the international price. Coal as a low-priced fuel substitute has contained the demand for LNG from power plants. We therefore believe although China has aggressively proposed 11 preliminary LNG terminals, it is not realistic to expect more than 5 LNG terminals in China before 2015. We expect only 3 LNG terminals will be built in Zhejiang, Shanghai and Hong Kong before 2015.

Against the backdrop of limited numbers of LNG terminals, we believe that city gas operators will be able to pass extra cost on to customers. Although case-by-case cost pass-through may not be realized immediately, it will be taking less and less time to be granted by local governments. We believe the temporary margin erosion is very minor as retail prices increments granted generally are higher than gas cost hikes.

*Full cost pass through in the mid term*

We conclude that city gas operators can pass extra cost to end users even if LNG imported at international prices from 2010-2015 based on the following analysis:

***Favorable policies to natural gas.***

China's energy polices favor use of natural gas. Natural gas was defined as a primary energy source. Low price and environmental friendliness of natural gas prompt China to vigorously promote its use. The Chinese government not only provides incentives to city gas operators for investments in city gas distribution but also sets out regulations to require or encourage C&I entities to shift from coal to natural gas. Now although LNG plans have cooled down a bit, the government is still interested in LNG, and still views it as a necessary part of the energy mix.

Moreover, the new gas pricing mechanism allows gas distributors to adjust gas tariffs to end-users to ensure stable and safe gas supply. China's natural gas is still at infant stage and city gas investment is capital intensive. We believe that 2004 to 2010 is a very critical time period for China to build a well-established city natural gas infrastructure countrywide. Hence, in our view, China will intend to grant city gas operators a full cost pass-through under the new pricing mechanism to encourage more private investments as majority of SOE city gas operators are lacking financial resources and are running in red.

***Longer time for China's domestic natural prices to catch up international prices***

With construction of LNG terminals slowing down, China has more time, 5-10 years, to adjust domestic natural gas pricing mechanism before exposing it to market force. It is reasonable to expect there will be longer time for the residential natural gas users to follow a supply/demand-driven pricing mechanism.

***Rich coastal cities will be able to afford cost pass-through***

All LNG terminals will be built in coastal areas, providing natural gas supplies to large population of affordable consumers.

We did a scenario analysis by comparing prices difference between Dongguang city's current city gas cost and LNG wholesale price in Guangdong under the assumption that LNG price in Guangdong is imported at the prevailing international market price. According to CNOOC, the current international price is Rmb 1.9/m$^3$ and domestic gas producers normally take 20% gross margin of wellhead price. After factoring in 0.3% gasification fee/m$^3$, 20% gross margin of wellhead price Rmb1.9/m$^3$, we came out a new selling price of CNOOC's Guangdong LNG terminal of Rmb2.28/m$^3$. We found out that actually Xinao's city gas cost in Dongguang was almost the same as CNOOC's new selling price. Xinao's LNG gross margins in Dongguang city are over 25%. We also noted, without natural gas sources, most cities in Guangdong and Zhejiang provinces used LPG at prices 20-30% above international natural gas price levels. Therefore we believe that coastal rich cities like Dongguang can afford natural gas at international prices and city gas operators are unlikely to have to face margin squeeze in coastal cities.

**Table 4: Prices comparison between domestic and international**

| | **Gas cost** (Rmb/ m$^3$) | **Retail prices** (Rmb/ m$^3$) | |
|---|---|---|---|
| **Dongguang city** | | Household | C&I |
| Gas sources: LNG from Xingjiang | 2.25 | 3.6 | 4 |
| **CNOOC** | **Gas cost (**Rmb/ m$^3$**)** | **LNG wholesale price (**Rmb/ m$^3$**)** | |
| LNG terminal in Guangzhou | 2.2 | 2.28 | |

(**Assumptions:** CNOOC imports LNG at prevailing international price of Rmb 1.9/ m$^3$, gasification fee is Rmb0.3/m$^3$, CNOOC takes 20% gross margin of the import price of Rmb 1.9/ m$^3$)

Source: CNOOC, FSSL estimates

*Pricing differentiation is variable*

***City gas retail prices in hinterland could be 15-20% lower than international levels***

If each household is expected to pay about Rmb 24 extra natural gas cost from 2006, it will have to pay on average Rmb400 per year in 05 to Rmb520 per year in 2010. Some households in poor areas may not be able to bear the burden. Fortunately the poor hinterland cities do not need to use imported LNG as they are very close to domestic natural gas supply sources. We believe that, to keep social stability, the Chinese government will keep city gas retail prices at an artificially low level for residential users, at which households in some poor areas can afford.

To protect the interests of both lower-income households and city gas operators, the government may take two possible approaches: to allow city gas operators to pass extra gas costs on to C&I uses, or to ask domestic gas producers to earn less gross margins and bear the additional costs, the same way the government is taking to domestic refined oil producers and power producers.

As China's oil and gas giants are stepping up efforts in finding energy resources to feed a booming economy, we believe there will be more and more natural gas reserves to be discovered domestically, reducing dependence on LNG imports. In April 06, Sinopec announced the discovery of Puguang Gas Field with aggregate proved recoverable reserves estimated at 251bn m$^3$, the largest and richest marine gas field ever discovered in China. This June CNOOC announced an offshore natural gas filed with estimated recoverable reserve of 4-6 trillion m$^3$.

## Upstream expansion to secure natural gas sources

*Diversifying into upstream*

According to the forecast by China natural gas department, China's demand for natural gas during 2005-1010 grows 26% yoy, while natural gas supply stands at 17% yoy. China looks certain to be in shortage of natural gas supply before 2008. Hence securing natural gas sources is critical for city gas operators to win new projects and ensure stable gas supply to end users.

Xinao has strategically tied up with natural gas upstream producers to invest in upstream gas and secure downstream city projects. In upstream, Xinao partnered with CNOOC building Weizhou Island LNG terminal in Guangxi province. Weizhouao phase I is operational in 2006, providing LNG 150k-200k $m^3$/per day. In downstream, Xiao co-operated with China Huayou Group, a city gas operator and a subsidiary of China National Petroleum Corporation, in securing the piped gas project in Luoyang City, Henan Province.

In addition, Xinao acquired a 15% stake in a coal conversion project in Inner Mongolia, aiming at diversifying gas sources and reducing dependence on major gas suppliers. Coal can be converted into more environmentally friendly DME, a substitute for natural gas and LPG. According to Xinao, DME business is profitable if crude oil price is higher than US$45/bbl and city natural gas cost Rmb 2/$m^{3.}$ As crude oil and natural gas prices stay at high levels, in our view Xinao's DME business is very likely to make profit in a long run. Xinao has produced 10,000 tones of DME in its small DME plant in its Bengbu project by the end of 2005, indicating Xinao has the technology know-how for such production. Xinao, a pioneer in DME conversion, stands ready to benefit from increasing popularity of DME in China in future.

**Table 5: China's natural gas production and demand forecast**

| Year | 00 | 05 | 10E | 15E | 20E |
|---|---|---|---|---|---|
| Demand (bn $m^3$) | 24.5 | 60 | 100 | 150 | 200 |
| Production (bn $m^3$) | 27.2 | 50 | 80-90 | 100-120 | 130-150 |
| Net imports (bn $m^3$) | | 10 | Oct-20 | 30-50 | 50-70 |
| Dependency on imports | | 17% | 10%-20% | 20-33% | 25-35% |

Source: China Energy Development Report 2003, CNPC, China Energy Statistical Yearbook 2005

**Table 6: Xinao's natural gas sources update**

| 000 m3 | 05A | 06E | 07E | 08E |
|---|---|---|---|---|
| W-E pipeline | 127,808 | 210,000 | 430,300 | 430,300 |
| Zhong-Wu pipeline | 104,000 | 180,000 | 340,000 | 505,000 |
| Guangdong LNG Terminal | | 90,000 | 203,000 | 226,000 |
| Other resources | 228,192 | 371,064 | 303,296 | 753,594 |
| **Total** | **489,362** | **851,064** | **1,276,596** | **1,914,894** |
| Minimum off-take in W-E pipeline | 89,466 | 177,000 | 387,000 | 387,000 |

Source: company information, FSSL estimates

### Fair value interest rate risk from interest rate swap

*No impact on cash flow*

On Aug 5, 05, Xinao issued a 7.375% high yield 7-year bond. To decrease its interest payment, Xinao enters an interest rate swap with 20 counterparts involved. According to the new accounting standard HKAS32 and HKAS39, all companies are required to enter the mark to market fair value into financial statements. Xinao's net profit is volatile to interest rate risk, but fair value loss, non-cash item, doesn't affect our valuation based on DCF model. In our P&L model, we didn't put our forecast of the fair value gain (loss) because it is difficult for us to do modeling on the future spread between CMS 10 (simply viewed as US 10 year T-bond) and CMS2 (simply viewed as US 2 year T-bond). Bloomberg's forecast modeling on the spread, CMS10 - CMS2, will be available early this August.

**Table 7: Xinao's Interest rate swap structure**

| Time period | Effective interest rate |
|---|---|
| 5 Aug05- 5 Aug06 | 3% |
| 5 Aug06- 5 Aug07 | 4% |
| 5 Aug07- 5 Aug12 | (6 M Libor+1.37%+0.5Y -7.375%) |

**Note**: Y= 12%x (no.of days when CMS10-CMS2<0)/365

Source: company information

**Xinao's hedging rational:** According to the forecasted interest rate movement based on the existing US economy, Xinao believes that the interest rate cycle is likely to finish in the second half of 2006. Then interest rates are expected to maintain at a stable level for a period of one to two years. After that, the interest rates are expected to fall due to the change of US economic conditions. CMS are swap rates in US for derivatives. The spread, CMS10-CMS2, was greater than zero (positive) for more than 10 years. The last time the spread <0 was in 1989 for about 20-30 days due to political events in China. The management believes the structure is very safe.

**Impact on financial statements:**

In FY05: Xinao booked mark to market Rmb 49m fair value loss in its finance costs. The other credit entry was entered in current liabilities as "derivative financial instruments". But it is only a book loss and has no impact on Xinao's cash flows.

In FY06: if the mark to market loss were less than Rmb49m, e.g., 45m, then it would reduce both Xinao's finance costs and current liabilities (derivative financial instruments) Rmb 4m (Rmb49m-Rmb45m) in 2006.

**Our understanding- the effective interest cost is key:** Xinao paid an effect interest rate of 3% in year 1, saving US$8.75m; Xiao will pay an effect interest rate of 4%, saving US$6.75m in year 2; if 6-month Libor stays higher than 6% at August any year in year 3-7, Xinao will pay an effective interest rate higher than 7.735%, its bond's coupon rate.

**Our forecast**: Bayclay Capital forecasted early this June that at the end of 2006 Fed fund rate would be 6% and 10 year US T-bond would be 5.5%, hence there would be an inversion of interest yield curve. In another word, the spread of CMS10-CMS2 is <0. If that happened, Xinao would book a fair value loss in P&L bigger than that in 05 due to a huge negative fair value of interest rate swap as both 6-month Libor and negative spread put Xinao's interest rate swap in a terrible situation.

## Healthy balance sheet

*Free cash flow expected in 07*

We expect Xinao's capex to be about Rmb1050m, Rmb900m and Rmb800m in 2006, 2007 and 2008 respectively. Its net gearing will be estimated at about 60% during 2006-08. We believe Xinao balance sheet is very healthy. We forecast its free cash flow will turn positive from 2007, supporting its high dividend payout ratio expected at 20% and 25% in 2007 and 2008 respectively.

# Attractive valuation

We value Xinao at HK$ 8.5 per share based on 10% discount to NPV of our DCF model (WACC at 9%, 50% of D/A, 1.23 beta and 2% terminal growth after 2015). Our target price should be supported by 16x 08 earnings. We still believe that Xinao deserves a premium to its peers given its strong fundamentals and a constituent in MSCI China Index since this June.

**Table 8: Valuation peer comparison**

| Name | Stock Code | Market Cap HK$ mm | PER 06E | PER 07E | PER 08E | ROE (%) 06E | ROE (%) 07E | Yield (%) 06E | Gearing (%) 05A |
|---|---|---|---|---|---|---|---|---|---|
| ***Xinao gas*** | ***2688*** | ***6,842*** | ***19*** | ***17*** | ***14*** | ***16*** | ***16*** | ***1.2*** | ***80*** |
| China Gas | 0384 | 3,594 | 22 | 17 | 15 | 12 | 13 | 0 | 72 |
| Panva gas | 1083 | 3,354 | 10 | 10 | 8 | 17 | 17 | 0 | 51 |
| HK & China gas | 0003 | 93,924 | 17 | 19 | 22 | 19 | 19 | 2.0 | 40 |

Source: Bloomberg, FSSL estimates

**Table 9: Assumptions on margins and gas sales of Xinao**

| | 04A | 05A | 06E | 07E | 08E |
|---|---|---|---|---|---|
| **Segment gross margin** | | | | | |
| Connection fee | 72% | 74% | 69% | 67% | 63% |
| Piped gas | 17% | 18% | 21% | 24% | 29% |
| Bottled LPG | 0.6% | 0.6% | 0.6% | 0.6% | 0.6% |
| Sales of gas appliances | 14% | 14% | 14% | 14% | 14% |
| **Gas sales ('000 m3)** | | | | | |
| Residential | 105 | 198 | 239 | 312 | 396 |
| C&I | 143 | 273 | 557 | 864 | 1,350 |
| Vehicle | | 4 | 5 | 24 | 54 |
| **Total** | **248** | **472** | **800** | **1,200** | **1,800** |

Note: there is 6% gas leaking rate per year for Xinao, so total gas volume bought each year is higher than total gas volume sold

# Summary of Financials

## Profit and Loss Statements

| FY-end Dec (Rmb m) | 04A | 05A | 06E | 07E | 08E |
|---|---|---|---|---|---|
| Revenue | 1,440 | 2,057 | 2,932 | 4,001 | 5,264 |
| Gross profit | 590 | 772 | 1,035 | 1,342 | 1,725 |
| Other income | 48 | 120 | 91 | 73 | 73 |
| SG&A | (260) | (332) | (434) | (593) | (780) |
| Other expenses | (19) | (26) | (36) | (40) | (53) |
| Operating profit | 359 | 534 | 654 | 782 | 966 |
| Finance costs | (43) | (127) | (124) | (161) | (116) |
| Associates &JV | (2) | 22 | 52 | 84 | 106 |
| Earning before tax | 313 | 429 | 582 | 705 | 956 |
| Tax paid | (9) | (39) | (81) | (120) | (220) |
| Minority Interest | (53) | (87) | (120) | (146) | (206) |
| Net profit | 252 | 303 | 375 | 433 | 534 |
| Depreciation | 70 | 110 | 154 | 189 | 219 |
| EBITDA | 429 | 644 | 809 | 971 | 1,185 |
| **Growth** | | | | | |
| Revenue (%) | 64% | 64% | 43% | 36% | 32% |
| EBITDA (%) | 118% | 50% | 26% | 20% | 22% |
| EPS-diluted (%) | 19% | 10% | 23% | 10% | 23% |

## Ratio Analysis

| | 04A | 05A | 06E | 07E | 08E |
|---|---|---|---|---|---|
| **Margins** | | | | | |
| Gross Margin (%) | 41% | 38% | 35% | 34% | 34% |
| EBITDA margin (%) | 30% | 31% | 28% | 24% | 23% |
| Net margin (%) | 18% | 15% | 13% | 11% | 10% |
| **Operating Performance** | | | | | |
| SG&A / revenue (%) | 18% | 16% | 15% | 15% | 15% |
| Effective tax rate (%) | 3% | 9% | 14% | 17% | 23% |
| Dividend payout (%) | 10% | 15% | 18% | 20% | 25% |
| Inventory turnover | 13 | 18 | 20 | 21 | 27 |
| Payable days | 204 | 204 | 138 | 135 | 135 |
| Receivable days | 83 | 101 | 83 | 77 | 73 |
| **Financial** | | | | | |
| Net debt to equity | 0.5 | 0.8 | 0.7 | 0.7 | 0.6 |
| Revenues / total assets | 0.3 | 0.3 | 0.4 | 0.5 | 0.6 |
| Total assets / equity | 2.5 | 3.2 | 2.8 | 2.8 | 2.8 |
| Interest coverage | 8 | 5 | 5 | 5 | 7 |

## Balance Sheet

| FY-end Dec (Rmb m) | 04A | 05A | 06E | 07E | 08E |
|---|---|---|---|---|---|
| Cash& cash equivalent | 912 | 1,784 | 744 | 485 | 614 |
| Trade receivable[1] | 331 | 579 | 674 | 861 | 1,071 |
| Inventories[2] | 107 | 116 | 144 | 191 | 197 |
| Other current assets | 259 | 373 | 373 | 373 | 373 |
| Current assets | 1,609 | 2,852 | 1,934 | 1,909 | 2,254 |
| Fixed assets | 2,650 | 3,535 | 4,428 | 5,136 | 5,715 |
| Others | 362 | 700 | 692 | 686 | 681 |
| L-T investments | 233 | 436 | 488 | 572 | 678 |
| Total assets | 4,853 | 7,522 | 7,542 | 8,304 | 9,327 |
| S-T bank loan | 643 | 566 | 100 | 276 | 500 |
| Trade payables[3] | 483 | 730 | 728 | 998 | 1,328 |
| Short-term liabilities | 122 | 245 | 255 | 375 | 457 |
| Others current liability | 13 | 140 | 140 | 140 | 140 |
| Total current liability | 1,262 | 1,682 | 1,223 | 1,790 | 2,425 |
| L-T bank loan | 1,221 | 2,981 | 2,541 | 2,356 | 2,256 |
| Others | 10 | 8 | 511 | 422 | 374 |
| Total liabilities | 2,493 | 4,671 | 4,275 | 4,567 | 5,055 |
| Minority interest | 438 | 519 | 615 | 732 | 897 |
| Shareholders' equity | 1,923 | 2,332 | 2,651 | 3,004 | 3,376 |
| Book value per share | 2.3 | 2.6 | 2.8 | 3.0 | 3.4 |
| Working capital (1+2-3) | (45) | (35) | 90 | 54 | (60) |

## Cash Flow Statement

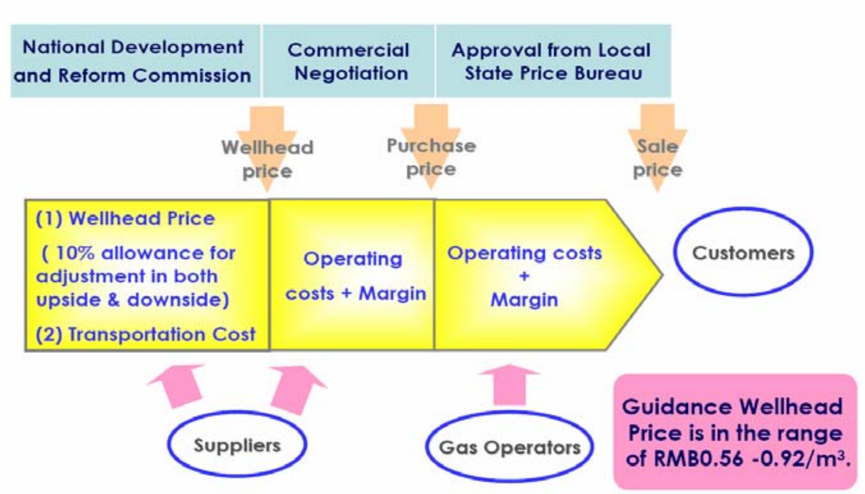
| FY-end Dec (Rmb m) | 04A | 05A | 06E | 07E | 08E |
|---|---|---|---|---|---|
| PBT | 313 | 429 | 582 | 705 | 956 |
| Depreciation and amortization | 70 | 110 | 154 | 189 | 219 |
| Change in Working Capt. | (78) | 10 | 125 | (37) | (114) |
| Tax Paid | (4) | (22) | (39) | 0 | (138) |
| Others | 6 | (128) | (314) | (273) | (220) |
| Operating CF | 307 | 399 | 508 | 584 | 704 |
| CAPEX | (918) | (1,004) | (1,050) | (900) | (800) |
| Free cash flow | (570) | (490) | (435) | 21 | 91 |
| Other Investing Activities | (258) | (271) | 0 | 50 | 100 |
| Investing activities CF | (1,176) | (1,275) | (1,050) | (850) | (700) |
| Change in Debt | (33) | 1,683 | (906) | (9) | 124 |
| Change in Equity | 504 | 53 | 0 | 0 | 0 |
| Dividends | 0 | (25) | (89) | (88) | (133) |
| Other Financing Activities | 822 | (125) | 639 | 104 | 135 |
| Financing activities CF | 1,293 | 1,586 | (356) | 7 | 125 |
| Chang in cash | 424 | 710 | (897) | (259) | 129 |
| Cash at the beginning | 488 | 912 | 1,621 | 724 | 465 |
| Cash at the end | 912 | 1,621 | 724 | 465 | 594 |

Source: Company information, FSSL

## Appendix: New natural gas pricing mechanism

NDRC on 23 Dec 05 set wellhead price pegged to other main energy prices. The wellhead prices were increased by 5-20% in 06, starting from Jan 06. After 06, the annual increase in future depending on market price on three main energy prices but is capped by 8% for Category Two natural gas fields. The guidance wellhead prices of Category One natural gas fields will be raised to a level similar to those of category two in 3-5 years. If transportation costs are increased, the overall initially increase in gas prices was 5-15% (in 06), and will be capped at 4-8% per year thereafter for Category Two.

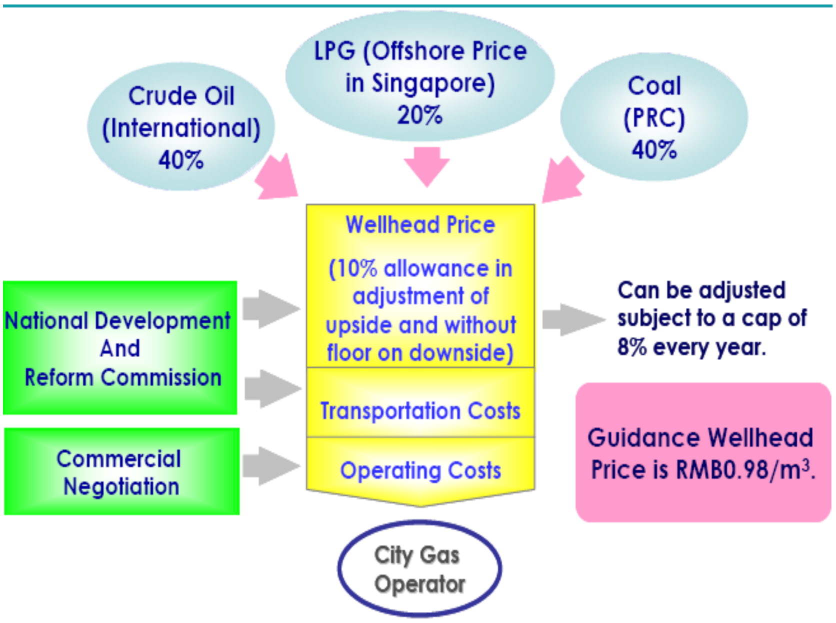
**Table 1: Pricing mechanism (Category One)**




Category one includes Chuanyu gasfield, Changqing oilfield, Qinghai oilfield and Xinjiang oilfields (excluding W-E pipeline), and part of natural gas reserves from Dagang, Liaohe and Zhongyuan oilfields.

Source: Xinao Gas, NDRC

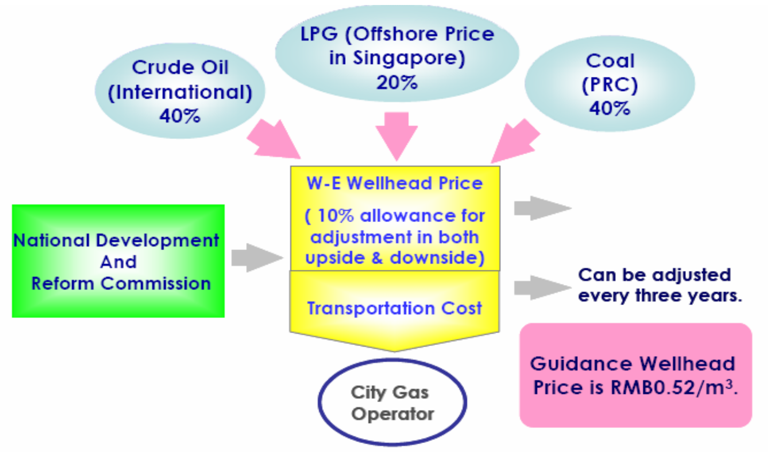
**Table 2: Pricing mechanism (Category Two)**




Category two includes all other gas reserves

Source: Xinao Gas, NDRC

**Table 3: Pricing mechanism (W-E Pipelines)**




Source: Xinao Gas, NDRC

## LNG terminals

### *First LNG terminal in Guangdong*

The long-term LNG supply agreement for Guangdong LNG terminal, the first one in China, has been signed several years ago with Australia at a very low price of about US$2.5/mmbtu (Rmb0.71/m3) for 25 years. City gas price is estimated at about Rmb 1.58/m3, close to the Rmb1.4-1.7/m3 price range for the W-E pipeline.

### *Second LNG terminal in Fujian*

Indonesia broke its agreement with CNOOC for China's 2nd LNG terminal in Fujian province and asked for US$3.5/mmbtu *(Rmb1.01/m3)*, 35% up from the original price of US$2.6/mmbtu. It was the second time for Indonesia to ask for higher prices. CNOOC accepts the new price asked. It is possible for Indonesia to raise price further, we believe that the final price to be settled in 2008 should be less than Rmb 1.12/m3, 50% increase from the original price.

**Table 4: LNG imported terminals in China**

| Facility | Capacity per annum M Tonnes | Construction Date | Operation Date | Operators |
|---|---|---|---|---|
| **Under construction** | | | | |
| Guangdong LNG | 3.7 | 2004 | 2006 | CNOOC and BP |
| Fujian LNG | 2.6 | 2006 | 2008 | CNOOC |
| **Proposed/in negotiation** | | | | |
| Zhejing LNG | | Proposed | Uncertain | CNOOC |
| Shanghai LNG | | Proposed | Uncertain | CNOOC |
| Qinghuangdao LNG | | Proposed | Uncertain | CNOOC |
| Hong Kong LNG | | Proposed | Uncertain | Exxon and CLP |
| Hainan LNG | | Proposed | Uncertain | CNOOC |
| Rudong LNG | | Proposed | Uncertain | PetroChina |
| Caofeidian LNG | | Proposed | Uncertain | PetroChina and Beijing Enterprise |
| Liaoning LNG | | Proposed | Uncertain | PetroChina |
| Shangdong LNG | | Proposed | Uncertain | Sinopec and China Huaneng |
| Zhuhai LNG | | Proposed | Uncertain | CNOOC |

Note: 1 ton LNG = 1,300 m3 NG

**Disclosure:** Should contain disclosure on FSSL's interest and relationship with the companies mentioned, if any. This box should appear in the middle of the last page, above the General Disclaimer box

**First Shanghai Securities Limited**

19/F Wing On House
71 Des Voeux Road Central
Hong Kong
Tel: (852) 2522-2101
Fax (852) 2810-6789