

### Target price upgraded to HK\$12.03

➤ **EPS in 06E upgraded to Rmb0.44:** We have upgraded Xiniao's 06 EPS from Rmb 0.41 to Rmb 0.44 on better-than-expected new connections and gas sales. The rapid development of China's property market prompts us to lift our forecast on Xiniao's new household connection from 45,000 to 48,000 households and Xiniao's gas sales volume from 800m to 850m m<sup>3</sup> in 06.

➤ **Automatic cost pass-through mechanism in China is under way:** We expect Xiniao to raise its retail tariffs for its 23-25 cities out of a total 28 that experienced rising upstream wholesale prices at the beginning of this year. It is possible that Xiniao fails to materialize cost pass-through in 3-5 cities where local governments strongly protect households' interests. However, according to industry sources, China NDRC plans to implement a new policy of automatic full cost pass-through to end users including households as improving income of Chinese people allows the government to take a more market-driven approach as far as utility expenses are concerned. We think that NDRC will likely speed up its reform on natural gas sector by allowing 10% yoy increase of upstream wholesale prices to narrow price gap between China and overseas countries. We are confident that the automatic cost pass-through mechanism for Chinese city gas operators is achievable in China as it is very important for China to build in a free natural gas pricing scheme.

➤ **Booming till 09:** More natural gas sources will be available in the coming years with the completion of PetroChina's W-E phase II, LNG terminals and Sinopec's Pugang pipeline planned linking Sichuan with Eastern China. Sinopec's Pugang Gasfield will mainly supply cities in Jiangsu province, Shanghai and Zhejiang province. Xiniao is homing in coastal rich cities of those provinces such as Fujian, Guangdong and Zhejiang, where demand for natural gas is robust. China's property market will continue to develop fast in the coming years as macro economic measures seemed having no significant negative impact, thanks to strong local demand and supports of local governments. We expect Xiniao to see its earning peak in 2009.

➤ **Reiterate BUY:** We have revised up our forecast on Xiniao's EPS by 7%, 12% and 11% for 06, 07 and 08 respectively. Our new target price is set at HK\$12.03 based on 21x PE FY07. We believe that Xiniao deserves a premium to the industry due to its strong growth momentum.

HK\$=RMB1.01

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Industry Natural gas distribution

Price HK\$ 9.50

Target price HK\$12.03  
 (+26.6%)

Old target price HK\$ 8.61

Stock code 2688

H-shr Market cap. HK\$8,960mn

H-share O/S 943mn

52wk high/low HK\$ 9.70/5.55

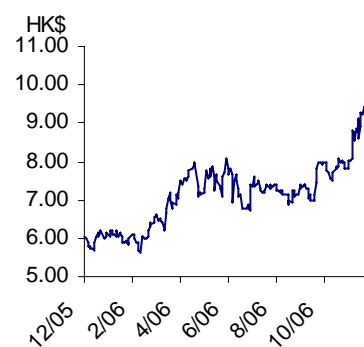
NAV per share HK\$2.58

Major shareholder Wang Yusuo (36.24%)

### Earning Summary

Year-end 31 Dec	FY04A	FY05A	FY06E	FY07E	FY08E
Turnover (Rmb m)	1,440	2,057	3,243	4,254	5,665
Growth (%)	64%	43%	58%	31%	33%
Net Profit (Rmb m)	252	303	418	567	687
Growth (%)	38%	20%	38%	36%	21%
Diluted EPS (Rmb)	0.29	0.32	0.44	0.57	0.69
Growth (%)	19%	10%	38%	30%	21%
PER (x)	33	30	22	17	14
DPS (Rmb)	0.03	0.05	0.08	0.11	0.17
Yield (%)	0%	1%	1%	1%	2%

### Price Performance



Source: company information, FSSL

Source: Bloomberg

# Automatic cost pass-through mechanism in China achievable

## LNG contract price in Shanghai is set at US\$6.34/mbtu

As one of the highly populous and most rapidly developing cities in China, Shanghai is eyeing the huge potential of natural gas to reduce its heavy reliance on coal and oil. Severe shortage of natural gas in Shanghai has been an obstacle to development of the city's natural gas utility sector and natural gas-fired power plants. At present, natural gas supplied to Shanghai comes mainly from Pinghu Gasfield in the East China Sea and PetroChina's W-E pipeline. Pinghu Gasfield's gas supply is limited in 06-08, keeping stable at 700m m<sup>3</sup> per year while W-E pipeline's new added supply of 5.1bn m<sup>3</sup> in 07 is planned to supply Eastern China. In July 06, China National Offshore Oil Corp, the parent of CNOOC (883 HK) and Shenergy Group, the parent of Shenergy (600642 CH), has agreed to buy LNG from Malaysian state oil company Petronas to meet Shanghai's consumption for 25 years at US\$6.34/mbtu (Rmb1.8/m<sup>3</sup>), which is 2 times of US\$3.10/mbtu gas cost from Australia for Guangdong LNG terminal and 2.5 times of US\$2.50/mbtu gas cost from Indonesia for Fujian LNG terminal. Shanghai LNG terminal's total designed annual capacity hits 6m tons. It is confirmed that Shanghai will invest Rmb6.7bn for its LNG terminal phase I with designed annual capacity of 3m tons. Petronas will initially deliver 1.1m tons (1.4bn m<sup>3</sup>) annually starting mid-09, ultimately rising to 3m tons (4bn m<sup>3</sup>) annually after 2012.

## Price difference for natural gas sources exists in Shanghai from mid-09 to 2012

Shanghai consumed about 2.5bn m<sup>3</sup> in 05 with around 1.8bn m<sup>3</sup> from PetroChina's W-E pipeline and 700m m<sup>3</sup> from offshore Pinghu Gasfield. Only Pudong in Shanghai uses natural gas while Puxi in Shanghai still burns coal gas. Currently, there is no price difference for end users of natural gas including households and C&I users, with city natural gas retail price set at Rmb2.10/m<sup>3</sup>. According to Shanghai Fuel Gas (Group) Co., Ltd, Shanghai is working on a plan to price differently the natural gas used for industrial and residential purposes. Under "Shanghai Blue Energy Plan" hammered out by the local government, natural gas will replace coal gas as the key energy source in Shanghai. It is projected that Shanghai will consume 8bn m<sup>3</sup> natural gas in 2010 (5bn m<sup>3</sup> for city gas use). All coal gas plants will be shut down by 2013.

From mid-09, Malaysian LNG will start to supply Shanghai. We think that city retail price of Shanghai LNG will be much higher than that of natural gas from PetroChina's W-E pipeline. We believe that it is unlikely for China to realize a free market natural gas pricing mechanism by 2009. In our view, high priced LNG will be supplied to those C&I users who use heavy oil for energy purpose or who can afford to use high-priced energy alternatives. It is not uncommon that the Shanghai Government forces some affordable companies to use LNG at high price, replacing coal as the main energy alternative, similar to what happened when natural gas from W-E pipeline was first supplied to Shanghai (Shanghai Government forced Baosteel to switch to natural gas). We believe that price difference for natural gas sources will temporally exist in Shanghai until 2012.

We believe that China has to speed up natural gas reform to address its shortage problems and increase the import of LNG at market prices. We think that it is highly possible that China NDRC allow natural gas upstream from year 06 or 07 to raise wholesale prices at 10% yoy instead of 8% cap set before.

## Automatic additional cost pass-through is achievable

Several provinces such as Sichuan, Hubei, etc. had implemented an automatic cost pass-through mechanism at the beginning of this year when the upstream raised natural gas wholesale prices. Beijing city adopted this mechanism this November. We believe that more and more cities will take similar steps. According to industry sources, NDRC is planning to implement a country-wide automatic natural gas cost pass-through mechanism similar to “coal cost pass-through” mechanism in China power sector. We believe that automatic natural gas cost pass-through mechanism is achievable in China within 1-2 years.

## BUY Xinao, a high quality brand at any undervalued price

We are very upbeat about both China's natural gas and property industries. Most of Xinao's concessionary cities are fast growing, offering better returns in a longer period than those of its peers like Hong Kong & China Gas (3 HK), China Gas (384 HK) and Panva Gas (1083 HK). Xinao's most cities are acquired at low prices and with low penetration rate and strong demand for natural gas.

Xinao Gas remains our top pick in China city gas sector. We have revised up our forecast on Xinao's EPS by 7%, 12% and 11% for 06, 07 and 08 respectively. We upgraded our target price to HK\$12.03 on our base year rolling over to FY07.

We think that Xinao Gas's any stock price under HK\$ 9.00 spells an opportunity to buy.

**Table 1: Valuation peer comparison**

Name	Stock Code	Mkt Cap HK\$ m	PE			ROE (%)			Yield (%)	Gearing (%) FY05
			FY06	FY07	FY08	FY06	FY07	FY08		
<b>Xinao Gas</b>	<b>2688</b>	<b>8,960</b>	<b>22</b>	<b>17</b>	<b>14</b>	<b>16</b>	<b>18</b>	<b>19</b>	<b>1.2</b>	<b>39</b>
China Gas	384	4,183	20	14	11	12	13	14	0	68
Panva Gas	1083	3,741	19	16	12	13	14	15	0	50
HK & China Gas	3	93,975	21	20	19	19	19	14	2.1	12

Source: Bloomberg, FSSL

**Table 2: Comparison between Xinao Gas and China Gas**

	2005	2006	2007	2008
<b>Gross Margin (%)</b>				
Xinao Gas	38%	37%	36%	36%
China Gas	48%	36%	32%	31%
<b>EBITDA margin (%)</b>				
Xinao Gas	31%	27%	27%	23%
China Gas	40%	28%	33%	19%
<b>Net profit margin (%)</b>				
Xinao Gas	15%	13%	13%	12%
China Gas	25%	18%	14%	12%
<b>Adjusted EPS growth (%)</b>				
Xinao Gas	15%	38%	30%	21%
China Gas	17%	19%	25%	21%

Source: Company information, FSSL

**Table 3: Assumptions on new connections and gas sales volume of Xinao Gas**

	FY04A	FY05A	FY06E	FY07E	FY08E
<b>Residential households new connections</b>					
Old forecast	253,395	334,637	450,000	585,000	760,500
New forecast			480,000	624,000	811,200
<b>Gas sales volume (m m<sup>3</sup>)</b>					
Old forecast	248	472	800	1,200	1,800
New forecast			850	1,275	1,913

Source: Company information, FSSL

## Financial Summary

## Profit and Loss Statements

FY-end Dec (Rmb m)	04A	05A	06E	07E	08E
Revenue	1,440	2,057	3,243	4,254	5,665
Gross profit	590	772	1,188	1,524	1,862
Other income	48	120	91	73	73
SG&A	(260)	(332)	(497)	(588)	(783)
Other expenses	(19)	(26)	(58)	(43)	(57)
<b>Operating profit</b>	359	534	724	967	1,096
Finance costs	(43)	(127)	(140)	(140)	(105)
Associates & JV	(2)	22	43	84	106
<b>Earning before tax</b>	313	429	627	911	1,097
Tax paid	(9)	(39)	(88)	(155)	(187)
Minority Interest	(53)	(87)	(121)	(189)	(228)
			0.38	0.36	0.21
<b>Net profit</b>	252	303	418	567	687
Depreciation	70	110	157	196	230
<b>EBITDA</b>	429	644	881	1,163	1,326
<b>Growth</b>					
Revenue (%)	64%	64%	58%	31%	33%
EBITDA (%)	118%	50%	37%	32%	14%
EPS-diluted (%)	20%	10%	37%	30%	21%

## Balance Sheet

FY-end Dec (Rmb m)	04A	05A	06E	07E	08E
Cash & cash equivalent	912	1,784	553	228	403
Trade receivable	331	579	807	825	1,099
Inventories	107	116	166	178	238
Other current assets	259	373	373	373	373
<b>Current assets</b>	1,609	2,852	1,897	1,604	2,114
<b>Fixed assets</b>	2,650	3,535	4,575	5,377	6,044
Others	362	700	692	686	681
L-T investments	233	436	479	563	669
<b>Total assets</b>	4,853	7,522	7,643	8,229	9,507
S-T bank loan	643	566	200	200	500
Trade payables	483	730	788	1,024	1,427
Short-term liabilities	122	245	255	285	365
Others current liab.	13	140	140	140	140
<b>Total current liab.</b>	1,262	1,682	1,383	1,650	2,432
L-T bank loan	1,221	2,981	2,430	2,121	2,021
Others	10	8	532	553	480
<b>Total liabilities</b>	2,493	4,671	4,345	4,324	4,934
Minority interest	438	519	616	767	949
<b>Shareholders' eqt.</b>	1,923	2,332	2,682	3,138	3,624
Book value per share	2.3	2.6	2.9	3.2	3.7
Working capital	(45)	(35)	184	(21)	(89)

## Ratio Analysis

	04A	05A	06E	07E	08E
<b>Margins</b>					
Gross Margin (%)	41%	38%	37%	36%	36%
EBITDA margin (%)	30%	31%	27%	27%	23%
Net margin (%)	18%	15%	13%	13%	12%
<b>Operating Performance</b>					
SG&A / revenue (%)	18%	16%	15%	14%	14%
Effective tax rate (%)	3%	9%	14%	17%	17%
Dividend payout (%)	10%	15%	18%	20%	25%
Inventory turnover	13	18	20	24	24
Payable days	204	204	138	135	135
Receivable days	83	101	90	70	70
<b>Financial</b>					
Net debt to equity	0.5	0.8	0.8	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	2.6	2.6
Interest coverage	8	5	5	6	10
ROE	13%	13%	16%	18%	19%

## Cash Flow Statement

FY-end Dec (Rmb m)	04A	05A	06E	07E	08E
<b>PBT</b>	313	429	627	911	1,097
Depreciation and amortization	70	110	157	196	230
Change in Working Capt.	(78)	10	219	(205)	(68)
Tax Paid	(4)	(22)	(45)	(125)	(107)
Others	6	(128)	(384)	99	(360)
<b>Operating CF</b>	307	399	574	876	793
CAPEX	(918)	(1,004)	(1,200)	(1,000)	(700)
<b>Free cash flow</b>	(570)	(490)	(505)	26	93
Other Investing Activities	(258)	(271)	0	150	0
<b>Investing activities CF</b>	(1,176)	(1,275)	(1,200)	(850)	(700)
Change in Debt	(33)	1,683	(917)	(309)	200
Change in Equity	504	53	0	0	0
Dividends	0	(25)	(95)	(113)	(172)
Other Financing Activities	822	(125)	550	72	54
<b>Financing activities CF</b>	1,293	1,586	(463)	(351)	83
<b>Change in cash</b>	424	710	(1,088)	(325)	175
Cash at the beginning	488	912	1,621	533	208
Cash at the end	912	1,621	533	208	383

Source: Company information, FSSL

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