

China / Hong Kong Industry Focus

China Gas Sector

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DBS Group Research . Equity

22 Sep 2022

Easing pressure on dollar margin

- **Higher gas supply from Russia is positive for gas procurement given the lower prices**
- **Dollar margin pressure in 4Q is manageable**
- **Sector trading at -1SD to -2SD of its 2-year historical average after correction of >20% in the past 1.5 months**
- **Top pick: [ENN \(2688 HK\)](#)**

More natural gas from Russia. Although total natural gas consumption was flat in 7M2022, growth from piped gas was strong. In particular, gas supply from the Power of Siberia jumped >60% during 8M2022. Including LNG imports, Russia is expected to be one of the major gas suppliers to China, accounting for around 15% of total imported natural gas supply in 2022. Not only will gas supply be more stable and diversified, we believe this is also positive for gas procurement as Russian gas is more competitively priced. In fact, the hike in gas cost for this winter is 10-15%, which we reckon is reasonable. We do not expect any issues in cost pass-through in this winter. Extreme weather will be a swing factor.

Dollar margin pressure in 4Q should be manageable. Amid uncertainty from the Ukraine crisis, dollar margin pressure of gas distributors in 4Q should be manageable because 1) high LNG prices have already deterred demand, prompting users to switch to alternatives; 2) lower percentage of spot LNG transactions and increasing spare capacity in PipeChina's LNG terminals are other signs that LNG prices have peaked; and 3) contracted volume will be set for residential users to ensure sufficient supply.

Trough valuation of -1SD to -2SD of historical average. The sector corrected as much as 20% after the interim results announcement. In fact, the sector has underperformed HSI by 9-40% YTD. We reckon uncertainties have been reflected. The sector's valuation is attractive, trading at a trough of -1SD to -2SD of its historical average. Upcoming catalyst is the National Party Congress to be held in October. Our top pick is ENN because it has the strongest core profit growth with the lowest risk in dollar margin.

HSI: 18,445

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Recommendation & valuation

Company	Price HK\$	Target Price HK\$	Recom	Mkt Cap US\$m
China Gas 384 HK	11.42	14.20	BUY	7,916
China Resources Gas 1193 HK	29.3	36.00	HOLD	8,639
Tian Lun Gas 1600 HK	3.71	3.70	HOLD	477
ENN Energy 2688 HK	109.5	149.0	BUY	15,774
Towngas Smart Energy 1083 HK	3.17	4.80	BUY	1,316

Source: Thomson Reuters, DBS Bank (Hong Kong) Limited ("DBS HK")
Closing price as of 21 Sep 2022



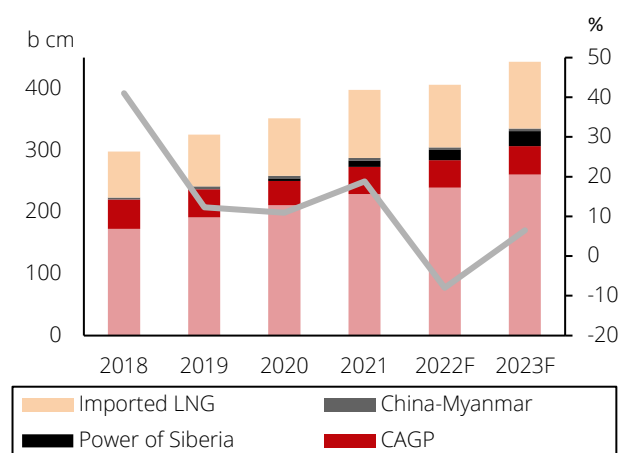
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China Gas Sector

More natural gas from Russia

Total supply of natural gas in China inched up around 2% in the first seven months of 2022. As shown in the chart below, domestic production of natural gas remained the major gas source in 2022, accounting for almost 62% of total supply in the first seven months of 2022 in terms of gas volume versus <58% in 2021. Total imports (including imported natural gas in gaseous and liquefied state) on the other hand, dropped by around 9% during the period. We note that the decline in imported LNG was more significant at 20%.

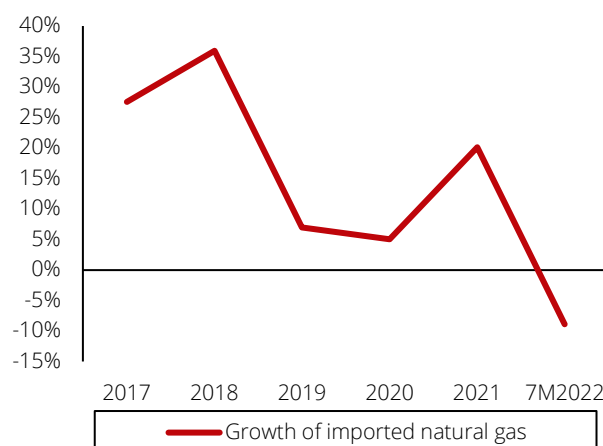
Breakdown of natural gas supply in China



Source: CEIC, DBS HK

Despite the fall in total natural gas imports, imports from Qatar and Russia increased significantly during 7M2022. In particular, Gazprom, the major gas supplier from Russia, cited that gas supplies to China through the Power of Siberia pipeline grew >60% during the first eight months of 2022. With daily volume of exports through this pipeline hitting an all-time high on 10 September, **we expect gas supply from Russia will continue to increase in 4Q2022**. In addition, upon the completion of the gas pipeline from the Kovyktinskoye field in the Irkutsk region to the Chayandinskoye field in Yakutia, gas supply from Power of Siberia will increase further in 2023. Northern and North-Eastern China will benefit from a more stable gas supply. In fact, ramp up of the pipeline has been faster than expected. **If full capacity can be reached by 2025, supply from Russia will increase from around 10% of total imported natural gas volume in 2021 to around 15% in 2022 and further to 18% in 2025.**

Growth of imported natural gas



Source: CEIC, DBS HK

As the price of Russian piped gas is generally at a discount of around 20% to other piped gas sources, increasing gas procurement from Russia will have a positive impact on gas cost and dollar margin for gas distributors. In fact, **the price hike by the three oil majors on gas supply during winter is not significant, by 10-15% from the same period last year (or 40-45% above benchmark price).**

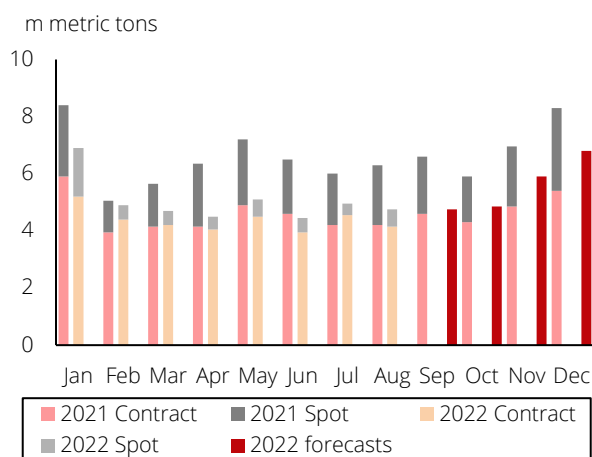
China has also agreed to buy an extra 10bcm (billion m³) from the Russian Far East route by 2026. In addition, the two countries are also in discussions on another new gas pipeline, Power of Siberia 2, to bring gas from the huge Yamal peninsula reserves in west Siberia, the main source of gas supply to Europe. If this materializes, this new pipeline is expected to come onstream in 2030, subject to political and commercial considerations. **China will then have a more diversified gas procurement in the long term.**

Dollar margin pressure in 4Q could be less than expected

According to BloombergNEF, China imported 40.1m tons of LNG in 8M2022, a 21.4% drop from the same period last year. However, spot LNG imports have dropped by a higher 64.9% to 5.3m tons. Spot LNG imports only accounted for 13.3% of China's total LNG imports in 2022, compared with 29.8% in the same period last year. **We reckon the decline in the share of spot LNG imports indicates that the current high spot LNG prices have deterred demand, and hence high prices are not sustainable.**

China Gas Sector

China LNG imports by type



Source: BloombergNEF, DBS HK

Data from PipeChina, where spare receiving capacity at its LNG terminals for 4Q delivery has increased, also showed weak demand for imported LNG.

In addition, in late August, Gazprom extended the shutdown of natural gas supply of Nord Stream 1 with no timeline for resumption of operation. This pushed LNG prices to new highs but not for long. The correction in LNG prices was triggered by proposed plans by the European Commission to cap Russian gas prices. While the geopolitical crisis in Europe will keep LNG prices elevated with high volatility, **we believe the current high level is already starting to dampen demand** and has triggered users to seek alternatives, such as electricity and coal. Hence, further upside in LNG prices is likely to be unsustainable.

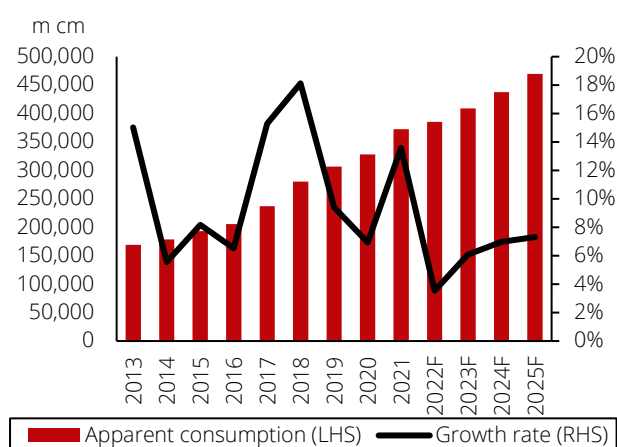
Note that the impact of high LNG prices on dollar margin depends on demand for uncontracted gas volume, i.e. higher the demand, the higher pressure on dollar margin. Contrary to past practice based on total contracted volume, PetroChina now evaluates gas demand in residential and non-residential markets and accordingly sets contracted volumes for each market for the upcoming winter. **This new practice would ensure sufficient gas supply for residential users and reduce the risk of gas distributors procuring extra gas volume from the spot market, hence lowering risk on dollar margin pressure.** The swing factor will be weather where an unpredictable cold snap could spike up gas consumption.

Downside risk on gas volume growth in 2022

Data from National Development and Reform Commission showed that natural gas consumption growth in China was flat in the first seven months of 2022. On a positive note, **the growth rate turned positive in July after recording negative growth in both May and June.**

After releasing a set of 33 stimulus measures in May, the government has further stepped up its efforts to shore up economic growth by rolling out a Rmb1 trn stimulus package in August. The positive impact from these measures is likely to be partly offset by COVID lockdowns in various parts of China. With this backdrop, most gas distributors have lowered their gas volume growth expectations for 2022 by at least 5ppts. Nevertheless, **the market is expecting more stimulus plans to be announced in the 20th National Party Congress in mid-October. This could be a catalyst for the sector.** Should the zero-COVID policy be relaxed, stronger economic growth and higher gas consumption could be expected; hence a stronger catalyst.

China natural gas consumption



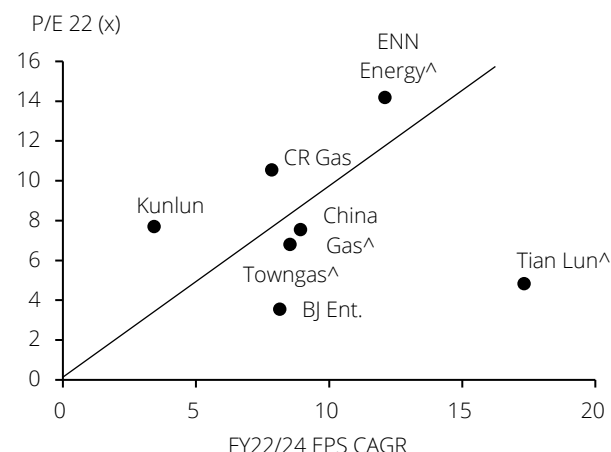
Source: CEIC, DBS HK

Trough valuation

After rebounding by >30% in 2Q2022, the sector corrected by as much as 20% after interim results announcement. **Gas distributors under our coverage are now trading at -1SD to -2SD of their 2-year historical average.** We reckon the trough valuation has already factored in the above uncertainties. A potential catalyst is if the current zero-COVID policy is relaxed after the National Party Congress.

Our top pick is ENN (2688 HK). It has a more diversified gas source where 5% of gas procurement comes from contracted LNG. Coupled with supply from 3 oil majors, ENN is able to secure contracted gas volume to as high as 94% of total procurement and could lower risk on dollar margin pressure, as international spot LNG prices are expected to stay elevated. It also has the highest core profit growth amongst the gas distributors under our coverage.

PEG comparison



Source: Thomson Reuters, DBS HK, ^Core EPS

Valuation comparison

															FY21-23		YTD	
Company Name	Code	Price HK\$	Mkt Cap HK\$m	Fiscal Yr	PE		Yield	Yield	P/Bk	P/Bk	EV/EBITDA		ROE	ROE	Earnings share	Net	gearing	
					22F	23F	22F	23F	22F	23F	22F	23F	22F	23F	22F	23F	CAGR	Perf.
Gas - Hong Kong																		
Beijing Enterprises	392 HK	24.50	30,901	Dec	3.6	3.2	6.0	7.0	0.3	0.3	6.6	5.7	9.2	9.3	(1.3)	(8.9)	37.2	33.2
China Gas*#^	384 HK	11.42	62,129	Mar	7.5	7.1	4.8	4.8	0.9	0.8	7.3	7.0	12.6	12.3	7.7	(29.5)	64.0	62.8
China Resources Gas*	1193 HK	29.30	67,801	Dec	10.5	10.1	4.4	4.7	1.4	1.3	5.7	5.4	14.5	13.5	2.3	(33.5)	6.2	0.8
Tian Lun Gas*^	1600 HK	3.71	3,747	Dec	4.8	4.1	6.0	7.8	0.6	0.5	5.7	5.3	11.5	13.4	(9.7)	(55.9)	77.4	79.0
Enn Energy*^	2688 HK	109.50	123,800	Dec	14.2	13.4	2.0	2.5	2.6	2.3	9.1	7.8	17.4	18.3	(0.5)	(25.4)	16.6	9.3
Kunlun Energy	135 HK	6.35	54,983	Dec	7.7	7.4	4.5	4.8	0.8	0.7	3.0	3.1	10.4	10.1	20.4	(13.1)	Cash	Cash
Towngas Smart Energy*^	1083 HK	3.17	10,330	Dec	6.8	6.5	4.7	4.7	0.4	0.4	8.9	8.3	8.3	6.3	19.1	(53.2)	84.3	72.0
					8.6	7.4	4.4	5.2	1.1	0.9	6.6	6.1	12.5	11.9	5.4		47.6	42.9

FY23: FY24; FY24: FY25, ^Core EPS

Source: Thomson Reuters, *DBS HK

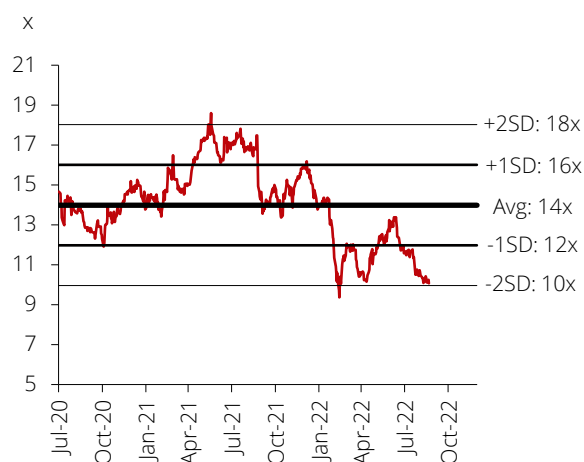
China Gas (384 HK) – PE Chart



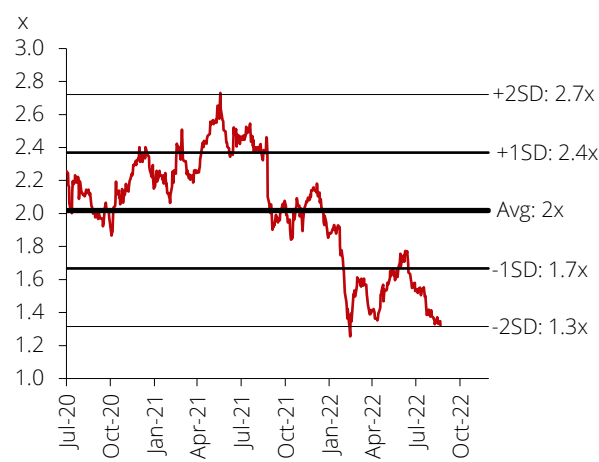
China Gas (384 HK) – PB Chart



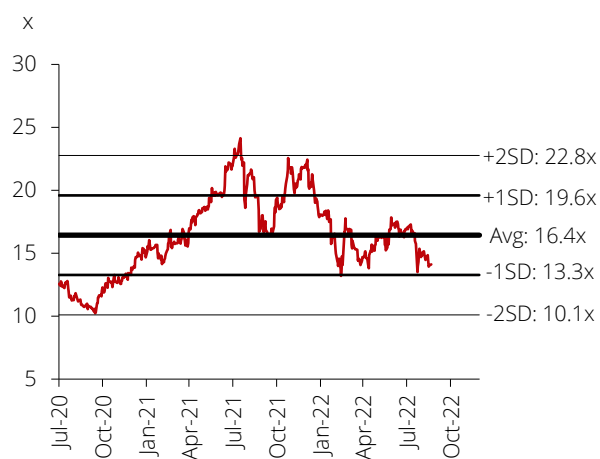
China Resources (1193 HK) – PE Chart



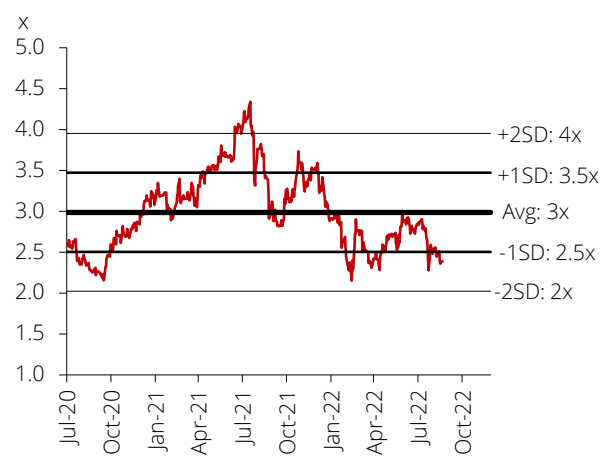
China Resources (1193 HK) – PB Chart



ENN Energy (2688 HK) – PE Chart

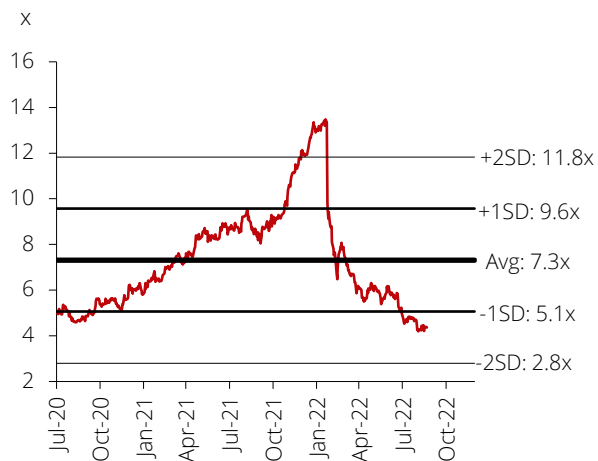


ENN Energy (2688 HK) – PB Chart

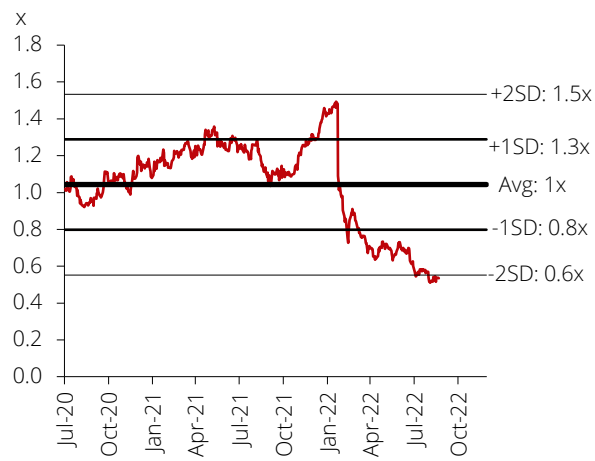


Source: Thomson Reuters, DBS HK

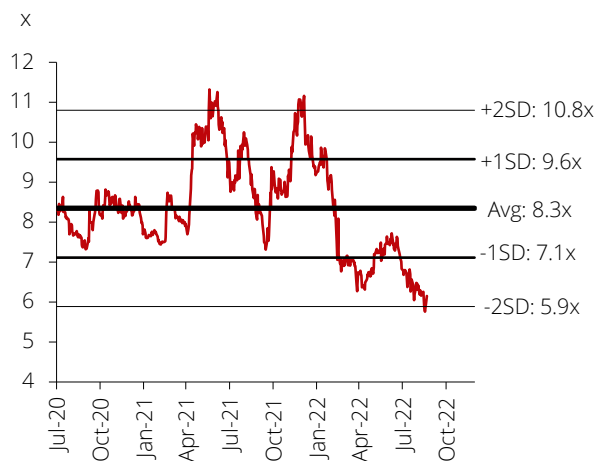
Tian Lun Gas (1600 HK) – PE Chart



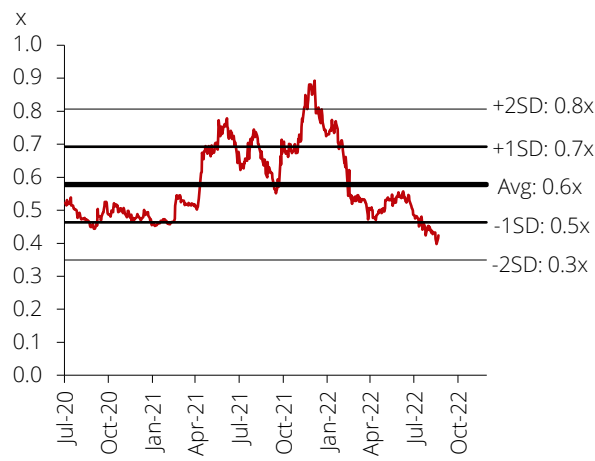
Tian Lun Gas (1600 HK) – PB Chart



Towngas Smart Energy (1083 HK) – PE Chart



Towngas Smart Energy (1083 HK) – PB Chart



Source: Thomson Reuters, DBS HK

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