

Kunlun Energy Company Limited

(135 HK)

Neutral

Price: HK\$6.72

25 Nov 2015

Price Target: HK\$6.80

PT End Date: 31 Dec 2016

Injection of Kunlun Gas possible within two years

PetroChina has signed a letter of intent to inject its downstream city-gas business, Kunlun Gas, into Kunlun Energy. This will give Kunlun Energy exclusivity on the deal for two years. Kunlun Energy can fund this acquisition by gearing up its balance sheet, on our estimates. If successful, this will allow Kunlun Energy to add gas supply capacity of >5B m³. We expect shares to react positively to the news as current share price has not factored in any potential asset injection, on our estimates.

- **Exclusive rights to acquire Kunlun Gas.** Kunlun Energy has signed a letter of intent with its parent, PetroChina, to acquire the latter's wholly-owned subsidiary Kunlun Gas. During the two-year validity period of this agreement, Kunlun Energy will have exclusive rights to acquire Kunlun Gas and PetroChina cannot engage in such discussions with other parties. Currently, PetroChina and its parent jointly own 62% of Kunlun Energy. Therefore, this asset injection would require the approval of minority shareholders.
- **Info on Kunlun Gas.** Kunlun Gas is a city-gas distribution company with projects in >20 provinces, c.100 cities and has a capacity of >5B m³. In comparison, Kunlun Energy sold 6.8B m³ of volume gas in 2014 and generated HK\$1.3B of operating profit from its natural gas sales segment.
- **Potential earnings upside of ~8%.** The addition of Kunlun Gas may allow Kunlun Energy to potentially increase its gas volume sales by ~70%. Assuming the new assets has similar margins as Kunlun Energy's existing gas projects, then the addition of Kunlun Gas could potentially add ~8% to Kunlun Energy's operating profit, on our estimates.
- **Kunlun Energy can gear up to fund the acquisition.** With net gearing of ~20%, Kunlun Energy could raise ~HK\$30B of debt by gearing up its balance sheet to 80%. We believe this would be more than enough to fund the Kunlun Gas acquisition.
- **Midstream pipeline not included in this agreement.** PetroChina announced its board has approved to implement an internal restructuring on its Trans-Asia Gas Pipeline Company, and will sell 50% of the reorganized company to an investment arm controlled by China Reform Holdings Corp for RMB15.0-15.5bn (c.US\$2.4bn), which is in charge of the reform of Chinese SOEs. We believe that PetroChina will continue to sell more of its pipeline assets due to financial pressure. However, it seems that PetroChina will be selling these assets to third parties rather than to Kunlun Energy.

PetroChina - H (0857.HK) is covered by J.P. Morgan Asia Analyst Scott Darling.

Investment Thesis

Kunlun Energy is the downstream natural gas subsidiary of CNPC. It is involved in natural gas distribution, gas transmission, LNG processing and terminal operation and oil exploration and production.

We have a Neutral rating on the company because it is vulnerable to weak oil prices and lower gas volume sales.

Valuation

Our Dec-16 PT is determined based on sum-of-the-parts valuation methodology. Our PT implies 13x FY16E P/E and 0.9x FY16E P/B.

Segment	Discount rate	Exit multiple/ terminal growth rate	Valuation methodology	NAV per share (HK\$)	% of total

E&P	10.3%	3x EBITDA	DCF	0.5	4.0%
Natural gas sales	10.3%	2.0%	DCF	1.7	15.1%
LNG terminal and processing	NA	1x P/B	P/B multiple	1.8	15.7%
Natural gas pipeline	10.3%	1.5%	DCF	7.4	65.2%
Net debt				(1.1)	
Minority interests				(3.4)	
Total				6.8	100.0%

Source: J.P. Morgan estimates.

Risks to Rating and Price Target

Downside risks to our PT include 1) lower-than-expected oil price and production volume; 2) lower-than-expected downstream gas sales volume, 3) potential cut in gas transmission tariff. Upside risks include: 1) faster-than-expected ramp up on natural gas refueling stations, 2) higher than expected processing volume on LNG terminal.

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Date	Rating	Share Price (HK\$)	Price Target (HK\$)
29-Oct-12	OW	13.86	17.50
02-Jul-13	OW	12.90	16.50
04-Aug-13	OW	11.50	15.00
01-Sep-13	N	11.30	12.80
14-Nov-13	N	12.62	13.50
11-Feb-15	N	7.87	8.00
31-Jul-15	N	7.09	8.50
07-Aug-15	N	7.10	8.20
17-Nov-15	N	5.90	6.80

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