

## Fuel and Electricity Prices Rise, Coal Prices Capped

### What's news?

- The National Development and Reform Commission (NDRC) last night announced a surprise RMB1,000/ton rise in gasoline and diesel prices and hiked jet-fuel prices by RMB1,500/ton. This raises retail prices for gasoline to RMB6,980/ton, up 16.7%, and diesel to RMB6,980/ton, up 18.1%. The price cap on jet fuel will be adjusted from RMB5,950/ton to RMB7,450/ton, up 20.1%. This is the first rise in gasoline and diesel prices in eight months, and comes amid growing inflation concerns in China.
- In addition to the price hike for refined products, the NDRC also announced a series of policies to help China IPPs suffering from profit pressure due to the increasing coal prices and tariff controls. IPPs can now raise industrial and commercial tariffs 4.7%, or 2.5 fen (c. 2.8 HK cents) per kW. Household and agricultural users and provinces affected by natural disasters will not be affected by this policy move. The NDRC also announced that it would freeze thermal-coal spot prices.

**Figure 1: Trading action**

Sector	Action	Stocks
Oil refiners	Buy	Sinopec (386.HK), PetroChina (857.HK)
Airlines	Sell	China Eastern Airlines (670.HK), Air China (753.HK), China Southern Airlines (1055.HK)
Automakers	Buy	Geely Auto (175.HK) – small-engine economy-car manufacturer
China IPPs	Buy	Huadian (1071.HK), China Power International (2380.HK)
Coal miners	Buy	Yanzhou Coal (1171.HK)

Source: Sun Hung Kai Financial

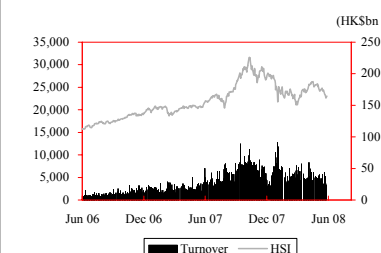
### Investment analysis

- Oil refiners – Higher fuel prices to drive share prices in the short term.** We believe **Sinopec (386.HK)** and **PetroChina (857.HK)** would benefit directly from raising fuel prices in the short term. However, we remain cautious, mainly due to the gap between China's price cap and international crude levels.
- Airlines – Raising jet fuel by RMB1,500/ ton negative to the sector.** The sector is undergoing a downcycle because of high oil prices. Jet fuel made up 35% of PRC airlines' operation expenses in FY07. Raising jet-fuel costs would further erode the profitability of domestic carriers.
- Automakers – higher fuel costs to hit private demand, but favorable to small cars.** We believe increasing gasoline prices will hit private demand for autos, but would be slightly positive for demand for small-engine economy cars.
- China IPPs – to benefit in the short term.** China IPPs have faced share-price pressure from rising coal costs and tariff caps. On average, coal makes up 70% of operating expenses for IPPs. Furthermore, 82.8% of power generation in China is produced from thermal power. Increasing industrial and commercial electricity prices 4.7% should help ease profit pressure on China IPPs.
- Coal miners – short-term selling pressure expected, we prefer Yanzhou Coal.** Among Hong Kong-listed PRC coal producers, we prefer **Yanzhou Coal (1171.HK, Buy)** since 20% of its production is of semi-soft coking coal. This type of coal is not subject to the latest price cap and can help make up the shortfall from the thermal-coal segment.

HSI	<b>22,813</b>
HSCEI	<b>12,362</b>

Performance (%)	1m	3m	12m
HSI	(9.4)	8.1	5.2
HSCEI	(11.5)	14.1	3.8

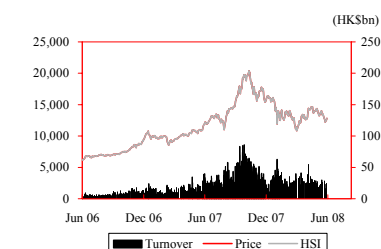
#### HSI Performance


 Closing **22,813**

 52W high/low **31,958/19,387**

Source: Bloomberg and Sun Hung Kai Financial

#### HSCEI Performance


 Closing **12,362**

 52W high/low **20,609/10,253**

Source: Bloomberg and Sun Hung Kai Financial

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**Oil-refining sector – We see short-term stimulus, but remain cautious in the long term**

- We believe price rises for refined products will provide a short-term stimulus for oil refiners including **Sinopec (386.HK)** and **PetroChina (857.HK)**, but remain cautious.
- The government move to hike gasoline and diesel prices is aimed at easing mounting losses for refiners, whose margins have been heavily hit by crude prices rocketing 91% from 2007 levels. Price hikes can also curb energy use and help achieve the government's target of a 5% reduction in energy intensity for every unit of GDP.
- We believe higher fuel prices should drive the share prices of Sinopec and PetroChina in the near future. However, we remain cautious as:
  1. The higher retail prices will not be enough to offset losses accumulated by refiners during the first half of the year.
  2. Even with the higher price caps, Chinese refined-product prices are still 57% cheaper than their international counterparts.
  3. The reduction in demand due to the price increases may offset any possible upside for the full-year results.

**Auto sector – Higher fuel costs should hit auto demand, but are slightly positive for small-engine economy cars**

- We expect gasoline and diesel price hikes to have a negative impact on the China auto sector and maintain our neutral view on mainland auto OEMs. We believe increasing gasoline prices will hit private demand for autos, but would be slightly positive for demand for small-engine economy cars.
- Apart from volatile gasoline prices, we believe the sector faces many other uncertainties during 2008, such as rising production costs and little room for most OEMs, especially PV producers, to raise selling prices. With so many factors going against auto OEMs, we see limited investment opportunities in this sector during 2008, and recommend investors to focus on stock selection.
- We believe the fuel-price hikes should be slightly positive to demand for small-engine economy cars. Producers of small cars, such as **Geely Auto (175.HK)** and **Great Wall Motor (2333.HK)** may suffer less negative impact from than other auto OEMs. Higher fuel prices may also accelerate investment by auto companies such as FAW to develop hybrid or energy-saving vehicles.
- Nonetheless, given the mostly negative news in the auto sector, we see few catalysts to drive share prices.

### Aviation sector - Hit hard by jet-fuel price hikes amid a sector downcycle

- We believe China aviation could be hit hard by jet-fuel price hikes amid a sector downcycle. Oil prices have soared since 2004, and jet fuel made up 35% of PRC airlines' operating expenses in FY07. This has significantly eroded the profitability of domestic carriers.
- Based on our sensitivity tests, all three domestic carriers – **China Eastern Airlines (670.HK)**, **Air China (753.HK)** and **China Southern Airlines (1055.HK)** – would become loss making if jet-fuel costs rise 1%. Also, the balance sheets of mainland airlines are stretched due to heavy capex for fleet expansion, which makes them vulnerable to rising interest rates. For example, CEA has budgeted RMB50.853bn for capex in 2008-10, mainly funded by bank borrowings and equal to 12X its H-share market cap. Rising inflation in China could also cut spending on discretionary items such as travel.
- This implies the domestic aviation cycle may trend down following 20% p.a. growth over 2004-07 since the trough of the SARS outbreak. We recommend investors steer clear of the sector.

### China IPP sector – Short-term winner

- We believe China IPPs are the winner from the latest electricity-price adjustment, and expect them to perform well in the short term.
- China IPPs have faced share-price pressure from rising coal costs and tariff caps. On average, coal makes up 70% of operating expenses for IPPs. Furthermore, 82.8% of power generation in China is produced from thermal power. Increasing industrial and commercial electricity prices 4.7% should help ease profit pressure on China IPPs.
- Among Hong Kong-listed China IPPs, our short-term picks are **Huadian (1071.HK)** and **China Power International (2380.HK)**, as based on our sensitivity tests they would benefit most from tariff and coal-price changes.

### Coal sector

- The NDRC announced last night that thermal-coal prices would be frozen at the 19 June level until 31 December 2008. This would cap the domestic benchmark QHD thermal-coal spot price at a record high of RMB860-880/tonne. The move is aimed at easing the margin pressure on Chinese IPPs caused by coal prices rocketing 60%-plus ytd. The cap applies only to thermal coal, not coking coal.
- Among Hong Kong-listed PRC coal producers, we prefer Yanzhou Coal (1171.HK, Buy) since 20% of its production is of semi-soft coking coal. This type of coal is not subject to the latest price cap and can help make up the shortfall from the thermal-coal segment.
- The stock has already corrected 16% since the Shandong provincial government's 2 June announcement that it would ensure sufficient coal supplies over the summer months. We believe the fall has been overdone, since the Shandong measures should cut Yanzhou Coal's net profit less than 0.1%.
- Furthermore, given structural demand growth and sustained supply tightness, the price cap should not affect FY08 profit, which we estimate to grow 63%. The stock trades at 12X FY08F and 10X FY09F earnings, lower than the sector average of 18X and 15X.

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