SECTOR UPDATE

Coal – China

Key Takeaways From BP's Annual Report On Global Energy

Due to price competitiveness, coal was unexpectedly the fastest-growing fossil fuel in the 2013 global energy consumption (+3% yoy) with market share reaching a record high of 30.1%. Oil & gas consumption grew 1.4% yoy each with market share easing to 32.9% and 23.7% respectively. While China's shift from coal-intensive industrialisation remains the main demand theme, the oil & gas market's tightness due to geopolitical risks may play a more important role in rebalancing the global coal market. Maintain MARKET WEIGHT.

WHAT'S NEW

- **BP recently released its global annual energy report** in which it reviewed the global energy landscape in 2013 and provides consumption projections into 2035. BP's report provided insights into coal supply and demand landscape relative to competitive sources of energy, such as oil, gas, nuclear, hydroelectric and renewables.

- **Three key developments in 2013**

  a) After two years of price decline, coal was the fastest-growing fossil fuel (up 3% yoy) in global energy consumption (up 2.3% yoy) in 2013, reaching a record high of 30.1% of global energy consumption.

  b) Natural gas consumption growth, however, decelerated and grew at a below-average 1.4% yoy, accounting for 23.7% of global consumption, down from 23.9% in 2012,

  c) Oil remained the world's leading fuel at 32.9% of global energy consumption, but its market share declined for the 14th consecutive year and was the lowest since 1965. Oil consumption in 2013 grew 1.4% yoy, just above the 10-year average of 1.3%.

- **Four key developments in 2035 (base case)**

  a) Global energy consumption will grow at an average of 1.5% p.a. (against GDP growth of 3.5%), with energy intensity declining 1.9% p.a. in 2012-35.

  b) Fossil fuels (coal, oil and gas) will lose market share but still the dominant energy form in 2035 with a share of 81%, down from 87% in 2013. Market shares of hydro and nuclear will remain flat at 7% and 5% respectively, while renewable energy's share will rise from 2% in 2013 to 7% in 2035.

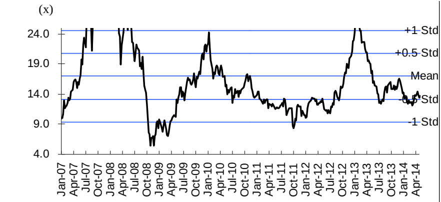
  c) Global coal consumption to grow 1.3% p.a. in 2012-35. China's shift from coal-intensive industrialisation will lead global coal share to fall to 27%, down from 30% in 2013. China's coal consumption in 2035 will be 52% of its energy consumption, down from 67.5% in 2013.

  d) Global oil consumption to grow 0.9% p.a. in 2012-35. Oil's share in global energy consumption continues to decline to 27% from 32.9% in 2013 with its position as the leading fuel challenged by coal. Global gas consumption is to grow 1.9% p.a. in 2012-35. Gas gains market share steadily to 27% from 23.7% in 2013.

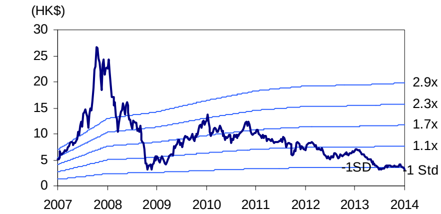
MARKET WEIGHT

(Maintained)

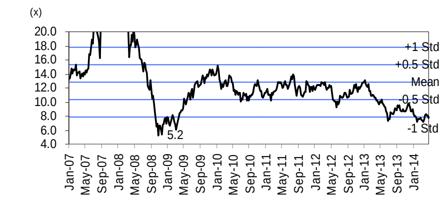
CHINA COAL - PE BAND



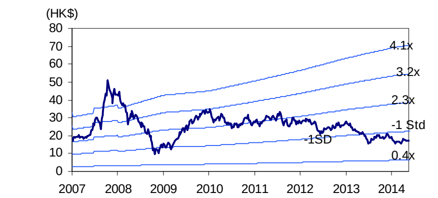
CHINA COAL – P/B BAND



SHENHUA - PE BAND



SHENHUA - P/B BAND



Source: UOB Kay Hian,

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PEER COMPARISON

Company	Ticker	Rec	Price @ 17/06/2014 (HK$)	Target Price (HK$)	Upside/ (Downside) to TP (%)	Market Cap (US$m)	1mth Chg (%)	3mth Chg (%)	YTD Chg (%)	PE 2014F (x)	PE 2015 F (x)	P/B 2014F (x)	P/B 2015 F (x)	EV/EBITDA 2014F (x)	EV/EBITDA 2015 F (x)	Yield 2014F (%)	Yield 2015 F (%)	ROE 2014F (%)	Net Gearing 2014F (%)
Shenhua	1088 HK	buy	22.05	31.6	43.3	48,036	3	11	(10)	8.1	7.9	1.1	1.0	4.6	4.4	4.9	5.2	14.1	10.5
Yanzhou Coal	1171 HK	hold	6.14	5.5	(10.4)	4,707	1	16	(13)	12.0	10.5	0.5	0.5	8.3	7.4	2.3	4.0	4.0	88.4
China Coal	1898 HK	buy	4.21	5.27	25.2	8,094	(2)	7	(3)	13.8	12.6	0.5	0.5	9.1	8.6	2.0	2.4	3.5	60.6

Source: Bloomberg, UOB Kay Hian

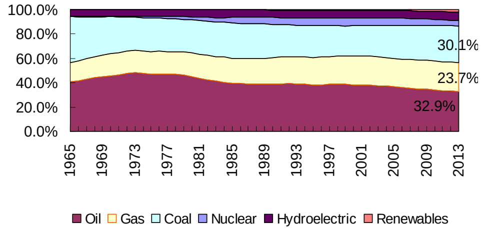
OUTLOOK

- **Coal market share expands on high oil & gas prices.** Coal-to-gas and coal-to-oil price ratios have been declining since 2012. With coal prices relative to oil & gas prices getting competititve, we are not surprised to see continuous market share expansion of coal in global energy consumption, as in 2012 and 2013.
- Going into 2014-16, China's steering away from coal-intensive industrialisation remains the key headwind for coal demand. However, high oil & gas price outlook due to tight supply may continue to play a more important role in reshaping global coal demand outlook. Coupled with coal production investment scale-back and small coal mine closures in China (accounting for 47.4% of global coal production in 2013), we expect coal prices to bottom in 2014 and are still of the view of a gradual recovery in 2015-16.
- **Global oil supply is facing two risks in supply tightness:** a) higher energy consumption per capita in OPEC countries (75% more than non-OECD countries) will limit the growth of both oil & gas exports, and b) historical precedent suggests supply disruptions take years to recover. These factors could pose risks to future global oil supply. China became the world's largest net oil importer in 2013 (with net imports of 7mn barrels per day (b/d) surpassing US's net imports of 6.5m b/d. Global oil supply disruptions and slowdown will affect China most.
- **US will not export gas any time soon.** Despite the fast growth in unconventional gas (shale gas) in the US, US remained a net importer of gas in 2013 with a supply deficit of 43.8m tonnes oil equivalents. Its gas supply accounted for 20.5% of the world's total and gas demand was 22.2% of the world's total. We do not expect US to become a net exporter in 2014-16.
- **Tension between Russia and Ukraine raises concern over gas supply in Europe.** Russia's gas supply and demand was 17.8% and 12.3% of the world's total respectively. Russia's gas has been mainly exported to Europe and Euroasia. With its tension between Ukraine escalating, Europe may face supply tightness and has to seek alternative supply, such as from the Middle East. We expect to see continuous tightness in the global gas market with the increasing geopolitical risk.
- **2013 global gas demand share declined on a tight gas market.** 2013 global natural gas consumption grew 1.4% yoy, while global gas production grew by only 1.1% yoy, well below the 10-year average of 2.6%. This explained why gas prices surged 34%, sending coal-to-gas ratio to the lowest since 2010. The rising gas prices made cheap coal gain share in the power generation and industry sectors.
- **Threat from non-fossil energy remains remote.** As for non-fossil energy, nuclear energy's and hydro-electricity's share of global energy consumption had been stable at 5% and 7% in 2013. BP expects little changes in their share into 2035. Renewables (including solar and wind) accounted for only 2% of global energy consumption and will increase to 7% in 2035. We think the threat of renewables to coal remains remote.

ACTION

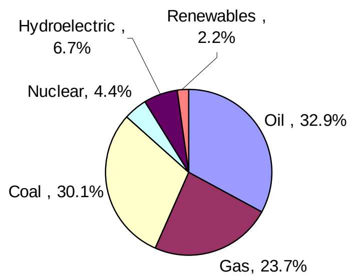
- BP report dismissed market concern over coal's declining market share in global energy consumption. The reality in 2013 was that coal demand growth was the fastest among other fossil fuels (oil & gas) and its market share reached a record high while market share of oil and gas eased.
- While China's shift from coal-intensive industrialisation will be the theme in the coming decades, however, 2013 reality shows that oil & gas prices may have more impact on coal consumption than other factors. Tight or rising oil & gas prices will induce a shift back to coal.
- Going forward, developments in the oil & gas markets, especially the escalating geopolitical risk, are indeed favourable for the coal market. Together with China's coal production and investment scale-back, we expect limited downside in coal prices. We maintain our forecasts for coal prices to recover to Rmb540/tonne in 2H14 and Rmb550/tonne in 2015. Key risks are faster-than-expected economic growth in China and the implementation of large-scale stimulus.

GLOBAL MARKET SHARE OF FOSSIL FUELS



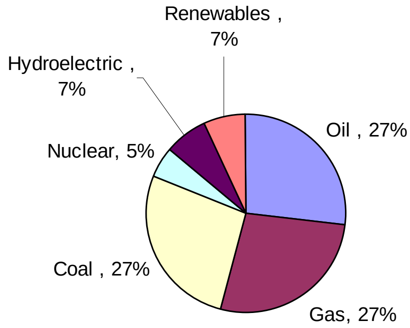
Source: BP, UOB Kay Hian,

2013 GLOBAL PRIMARY ENERGY BREAKDOWN



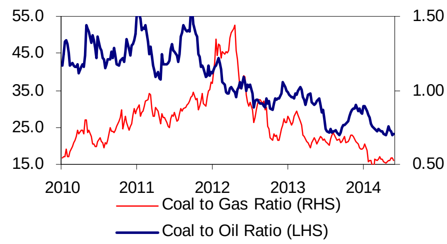
Source: BP, UOB Kay Hian,

2035 GLOBAL PRIMARY ENERGY BREAKDOWN



Source: BP, UOB Kay Hian

COAL TO GAS AND OIL PRICE RATIO DECLINING



Source: Bloomberg, UOB Kay Hian

GLOBAL GAS SUPPLY DEMAND BREAKDOWN

	2013 Gas Supply	2013 Gas Demand
North America	26.7%	27.8%
US	**20.5%**	**22.2%**
Central & South	5.2%	5.0%
Europe & Euroa	31.0%	31.7%
Russia	**17.8%**	**12.3%**
Middle East	16.7%	12.8%
Africa	6.0%	3.7%
Asia Pacific	14.4%	19.0%
China	**3.4%**	**4.8%**
Total	100.0%	100.0%

Source: BP, UOB Kay Hian

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