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RESEARCH UPDATE



China Natural Gas, Inc.
(NasdaqGM: CHNG)

APRIL 23, 2010 | TARGET PRICE: \$19.50 | RATING: STRONG BUY

2010 REVENUE AND EARNINGS ARE SET TO EXPLODE

Construction of LNG facility progresses toward June 30 start date. According to management, the start date of the Company's Jingbian County liquefied natural gas (LNG) plant is June 30, 2010. Recently released images (taken April 17, 2010) of the plant's construction progress are shown below.

ANALYST

Clay Mahaffey, CFA

MARKET DATA

TICKER	CHNG
FISCAL YEAR	DECEMBER
SECTOR	OIL & GAS SERVICES
RECENT PRICE	\$19.50
MARKET CAP	\$156.9M
52-WEEK HIGH - LOW	\$8.09 - \$0.55
PRICE/EARNINGS (TTM)	9.3X
PRICE/BOOK (MRQ)	3.1X
PRICE/SALES (TTM)	2.3X
SHARES OUTSTANDING	21.2M
FLOAT	12.8M
AVG DAILY VOLUME (3 MOS)	129,938
INSIDER OWNERSHIP	32.8%

As of January 25, 2010

FINANCIAL DATA

REVENUE (TTM)	\$57.3M
REV (TTM) PER SHARE	\$2.53
QRTL REV GRWTH YOY	139.0%
GROSS PROFIT (TTM)	\$30.3M
OPERATING MARGIN (TTM)	41.6%
EBITDA	\$23.8M
NET INCOME (TTM)	\$14.7M
DILUTED EPS (TTM)	\$0.66
QRTL EPS GRWTH (YOY)	171.4%
CASH & EQUIV (MRQ)	\$11.3M
CASH (MRQ) PER SHARE	\$0.46
TOTAL DEBT/EQUITY	44.5%
BOOK VALUE PER SHARE	\$1.90
ROE (TTM)	44.2%
ROA (TTM)	22.5%



Laying Plant Infrastructure



LNG Storage Tank



Pipeline Rack



Compressed Air / Nitrogen Station

Our sales estimates for 3Q10 are 25% of capacity (10 million cubic meters) and rise to 40% of capacity in 4Q10. Our estimates of 25% gross margins are conservative according to management. We expect LNG sales to represent 9% of 2010 revenue and 5% of gross margin in FY10.

Additional LNG growth prospects. The Company recently announced agreements with four cities along the Yangtze River to build LNG refueling stations. The Yangtze River is a 2,300 mile river flowing from the western provinces (near China's natural gas fields) to the major cities along the eastern seaboard (Nanjing, Shanghai, etc). An estimated 130,000-150,000 vessels are in operation on any given day. A total of 58 facilities (harbor and inland LNG



Fueling stations and reserve stations) were announced. The capacity and timing were not announced and therefore have not been included in our financial projections or target price calculations. The Company previously announced they were working on an engine modification to enable diesel engines to run on LNG. We believe this is a very strong announcement both from the financial considerations as well as strengthening CHNG's position strategically.

Natural gas mid stream strategy. The natural gas infrastructure and mid stream assets in China are not well developed. Gas is pumped via pipelines from the well head to consuming locations. The seasonality of consumption is increasing significantly due to winter heating loads as compared to transportation uses which have little seasonality. In fact, a cold snap in China last winter resulted in gas shortages and allocation of supply (with preference given to consumer heating) since there is little storage capacity to accommodate increased demand. However, CNPC has announced that it will build the largest natural gas storage facility in China with 12 billion cubic meters capacity. This storage facility is in the vicinity of CHNG's Jingbian LNG and provides the Company a stable long-term supply of natural gas at a "preferential cost" according to CHNG. That would even out the supply for CHNG and put the Company in a good position to become a leader in the mid stream sector. The economic returns are not clear at the moment, but reflect an aggressive strategy to build a substantial company well beyond the initial CNG refueling business.

CNG expansion in Henan province marks formal launch of JV. CNPC Kunlun Natural Gas Co. has announced that it has received local government approval to build one compressed natural gas (CNG) compressor station and six fueling stations in Henan Province. The development marks the formal launch of the joint venture between China Natural Gas, Inc. and CNPC in this region. This announcement also comes on the heels of CHNG's March conference call in which management stated they expect to acquire or build 40 refueling stations in 2010 which represents a 110% increase over year end 2009.

We estimate the investment in CNG fueling stations to cost roughly \$8 million with \$4 million attributable to CHNG through a 51%/49% CPNC/CHNG partnership. The CNG station expansion is expected to have a 3-4 year payback period.

CNPC is the largest oil & gas producer in China. They control much of the natural gas production in the country's western provinces as well as developing major pipelines to bring gas to the Chinese markets. CHNG gains the assurance of natural gas supply, local, regional and national government political support and preempts competition by making acquisitions of smaller facilities more probable.

Lingbao acquisition addressed. As we reported in our March 11 research note, CHNG has responded to questions and allegations regarding the propriety of the 2008 Lingbao acquisition with the Chairman and CEO, Mr. Qinan Ji, clearly and forcefully answering investors' questions on the fourth quarter earnings call. We now learn that Susan Wu of Frazer Frost, LLP, the auditor of CHNG, has looked closely at the transaction and determined that nothing was illegal or even an insider transaction. In addition, a recent due diligence trip by a group of funds led by a well known investment banking firm found the allegations of the "related party transaction" are false.

**OUTLOOK**

RedChip Estimates								
	FY08A	FY09A	1Q10E	2Q10E	3Q10E	4Q10E	FY10E	FY10E YoY Growth
Revenue	67.7	81.1	23.9	28	35.5	41.5	128.9	58.9%
Gross Profit	32.7	40.2	11.5	13.4	16.0	18.3	59.1	47.1%
Gross Margin	48.3%	49.6%	47.9%	48.0%	45.0%	44.0%	45.9%	-3.7%
Operating Income	21.1	25.1	7.5	9.4	11.7	13.9	42.5	69.3%
Operating Margin	31.2%	30.9%	31.4%	33.6%	33.0%	33.5%	33.0%	2.0%
Net Income	15.2	18.8	5.8	7.5	9.4	10.8	33.5	77.8%
Net Margin	22.4%	23.2%	24.4%	26.6%	26.4%	26.1%	26.0%	2.8%
EPS	\$1.04	\$1.13	\$0.28	\$0.35	\$0.44	\$0.51	\$1.58	39.9%

INVESTMENT CONCLUSION

CHNG currently trades at approximately 50% of our price target. Presumably, this is due to a low level of awareness, misperception of initial transactions and resulting short sales, uncertainty as to the LNG project and a high level of perceived country risk. The short sales will have to be covered at some point (refer to the March 11, 2010 research note for more information) and the perceived country risk has to be evaluated in terms of the fact that CHNG has secured a partnership with the largest oil & gas producer and supplier in China. Additionally, the LNG project will remain a small part of the Company's earnings and valuation for the next few years so concerns of a delay or slow sales, we believe is a red herring. The LNG Project is reported to be on schedule, but our model assumes it only contributes \$0.12 to EPS in FY10 due to the lag between start up and sales.

Trading at 6.3x 2010 projected EPS of \$1.58 we believe CHNG shares are very undervalued especially considering the excellent long-term growth prospects. Furthermore, our \$19.50 price target assumes no capacity increases beyond 150 million CM/yr, leaving even greater upside potential.