We are maintaining our Underperform recommendation on PetroChina ADRs. The weak crude pricing environment since July 2014 has been affecting the company's upstream operations. On top of that, we don't see any immediate spike in crude prices with plentiful supplies in the face of lackluster demand. Moreover, the company's operating expenses have been constantly rising over the last two years. If this trend continues, the company's future earnings might be hampered. We also remain concerned about the company's oil production growth prospects, considering its heavy exposure to significantly mature producing areas. Owing to these factors, we see PetroChina as a risky bet that investors should exit.
OVERVIEW

PetroChina Company Limited (PTR) is the largest integrated oil company in China. The company's activities include: the exploration, development, production and sale of crude oil and natural gas, the refining, transportation, storage and marketing of petroleum products, the manufacture and sale of chemical products, and the transmission of natural gas, crude oil and refined products.

PetroChina was established in November 1999 as a part of a restructuring of China National Petroleum Corporation (CNPC), a state-owned entity, which currently holds a majority stake of 86.35% in PetroChina. The company operates in four segments: Exploration & Production, Natural Gas & Pipelines, Refining & Chemicals, and Marketing.

- **Exploration & Production**: PetroChina is one of the largest producers of crude oil and natural gas in the world, with 2013 production of 932.9 million barrels of crude oil and 2,801.9 billion cubic feet (Bcf) of marketable natural gas. As of year-end 2013, the company had approximately 22.4 billion barrels of oil equivalent in proved reserves (increased nominally from previous year), of which approximately 48.4% was liquids (56.7% proved developed) and the rest natural gas (47.3% proved developed).

Most of PetroChina's crude oil and natural gas reserves and production-related assets are located in China, principally in northeastern, northern, southwestern and northwestern China. The Songliao basin, located in Heilongjiang and Jilin provinces in northeastern China, including the Daqing and Jilin oil regions, accounts for approximately 40% of the company's proved crude oil reserves and production. The company also has significant crude oil reserves and operations in the area around the Bohai Bay, including the Liaoh, Dagang, Huabei and Jidong oil regions, which makes up roughly 20% of its proved crude oil reserves and production. PetroChina's proved natural gas reserves and production are generally concentrated in northwestern and southwestern China, specifically in the Erdos, Tarim, and Sichuan basins.

- **Natural Gas & Pipelines**: PetroChina is the largest transporter and seller of natural gas in China in terms of sales volumes. The company sells natural gas primarily to fertilizer and chemical companies, commercial users and municipal utilities owned by local governments. Its existing natural gas pipelines form regional natural gas supply networks in northwestern, southwestern, northern and central China, as well as the Yangtze River Delta. PetroChina's midstream assets include a vast network of natural gas pipelines, with a total length of roughly 21,304 kilometers, representing the bulk of China's onshore natural gas pipelines. A major midstream project is the 4,843-kilometer west-to-east pipeline II that transports gas produced in the company's natural gas fields in the western and southwestern regions of China to large potential markets in eastern China. In October 2004, PetroChina completed the construction of the main line of the west-to-east pipeline and commenced commercial operation in December 2004. Since then, it has built 3 connecting pipelines for this project. As of Dec 31, 2013, the company owned and operated a crude oil pipeline network of 17,614 kilometers, natural gas pipeline network spanning 43,872 kilometers, and refined product pipeline network of 9,534 kilometers.

- **Refining & Chemicals**: PetroChina's refining operations include 2.58 million barrels per day in refining capacity. PetroChina operates 29 refineries located in eight provinces, four autonomous regions and one municipality. The company's operations include the refining, transportation, storage and marketing of crude oil, and the wholesale, retail and export of refined products, including gasoline, diesel, kerosene, lubricant, paraffin, and asphalt. In 2013, PetroChina's refineries processed 992.3 million barrels of crude oil and produced approximately 90.28 million tons of gasoline, diesel and kerosene.
The company is also the second largest manufacturer of chemicals in China, producing and selling a wide range of basic and derivative petrochemical products and other chemical products through 17 chemical plants and 4 chemical products sales companies. PetroChina’s chemical plants and sales companies are located in six provinces, three autonomous regions and two municipalities under the direct administration of the central government in China.

- **Marketing:** The firm’s marketing operations include a distribution network of more than 20,000 retail sites, 23 regional sales and distribution branch companies, and one lubricants’ branch company. Additionally, the company markets a range of refined products, including gasoline, diesel, kerosene and lubricants, through a network of sales personnel and independent distributors and a wholesale and retail distribution system across China.

**REASONS TO SELL**

- Though the Chinese oil companies are able to charge close to market prices for their crude oil volumes (typically with about a one-month lag and heavily taxed by the government), the government caps the prices of refined-products (particularly gasoline and diesel) to control inflation. These price regulations do not allow PetroChina to pass high refining costs on to consumers.

- Another long-term concern for PetroChina is its prospects in oil production. With about a third of its current crude oil volumes coming from the Daqing Oil region, the company is heavily exposed to this area. The Daqing Oil region is the largest crude oil producing area in China, but has significantly matured over the years and is currently well past its prime. As the degree of difficulty in extracting crude oil from the mature Daqing field increases over time, costs at these fields continue to increase.

- The crude oil pricing environment has been weak since Jul 2014. Moreover, we don’t expect any immediate spike in crude prices in the coming months with the commodity being over supplied in the face of lackluster global demand. These are expected to considerably hamper PetroChina’s upstream businesses as the company will not be able to generate sufficient cash flows after selling crude at low prices.

- PetroChina’s total operating expenses have been rising for the last two years, which is a serious concern. In 2013, the company spent roughly RMB 2,069.5 billion on operating activities, higher than RMB 2,020.8 billion and RMB 1,821.3 billion expended during 2012 and 2011, respectively.

- PetroChina has been exploring expansion and acquisition opportunities offshore and abroad to reduce its exposure to mature domestic areas. But given the competitive pressures from its domestic and international peers as well as regulatory constraints, limited meaningful progress has been made thus far. This situation is not expected to materially change any time soon.
RISKS

- PetroChina's results are heavily levered to changes in the overall energy price environment, which are inherently volatile and subject to complex market forces. Realized prices could differ significantly from our estimates, thereby affecting the company's revenues, earnings and cash flows. This may present a potential risk to our recommendation.

- Chinese politics and economics and changes to the country's energy legislation may have important effects on PetroChina. Any development on this front will have a positive impact on the company's financial condition and results, and will hamper our recommendation.

- A lucrative growth area for the company is its natural gas business, which is expected to witness strong growth in the coming years as China moves from coal to natural gas. At present, two-thirds of China's electricity is generated by coal-fired power plants, which emit greenhouse gases that lead to pollution. Success on this front may adversely affect our recommendation.

RECENT NEWS

Third Quarter 2014 Results

On Oct 29, 2014, PetroChina announced third-quarter 2014 earnings of RMB 27.9 billion or RMB 0.15 per diluted share, compared with RMB 29.8 billion or RMB 0.16 per diluted share in the year-earlier period. Earnings per ADR came in at $2.45 (exchange rate: US$1.00 = RMB 6.16, 1 ADR = 100 shares), failing to beat the Zacks Consensus estimate of $3.09. The underperformance is primarily attributable to poor petroleum products demand.

However, PetroChina's total revenue for the three months increased 3.3% from the year-earlier period to RMB 600.6 billion, driven by higher output.

Nine-Month Segment Performance

Upstream: PetroChina posted strong upstream output growth during the nine months ended Sep 30, 2014. Total volumes increased 2.5% year over year to 1,065.8 million barrels (MMBbl). Crude oil output remained essentially flat from the year-ago period at 700 MMBbl, while marketable natural gas output was up 7.1% to 2,193.9 billion cubic feet (Bcf).

Average realized crude oil price during the first nine months of 2014 was $99.93 per barrel, little changed from the corresponding period of the previous year. However, average realized natural gas price was $6.40 per thousand cubic feet (Mcf), 16.8% above the year-ago level.

This pushed down the upstream (or exploration & production) segment profit by roughly 1% to RMB 146 billion.

Downstream: PetroChina’s refinery division processed 746.4 MMBbl during the nine-month period, up from 734.5 MMBbl in 2013. The company produced 5.885 million tons of synthetic resin in the period (a rise of 22.4% year over year), besides manufacturing 3.688 million tons of ethylene (up 26.3% from the first nine months of 2013). It also produced 68.008 million tons of gasoline, diesel and kerosene during the period, against 66.758 million tons a year earlier.
The company’s Refining & Chemicals business experienced an operating loss of RMB 8.8 billion, considerably narrower than the loss of RMB 20 billion in the year-earlier period. The improved result in the downstream division was due to PetroChina’s ability to process load and optimize resource allocation.

**Natural Gas & Pipelines**: Due to the absence of certain one-time gains from last year, PetroChina’s natural gas business incurred a profit of RMB 9.2 billion during the first nine months of 2014, down by 60.6% billion from the year-earlier level of RMB 23.4 billion.

**Marketing**: In marketing operations, the group sold 117.573 million tons of gasoline, diesel and kerosene during Jan–Sep 2014, reflecting a 1.5% year-over-year decrease.

However, segment earnings jumped 57.6% year over year to RMB 10.6 billion, owing to PetroChina’s focus on high margin refined products like aviation kerosene.

**Liquidity & Capital Expenditure**

As of Sep 30, 2014, PetroChina’s cash balance was RMB 74.3 billion, while net cash flow from operating activities was RMB 254.7 billion. Capital expenditure for the period reached RMB 188.9 billion, down 6.3% from the year-ago level of RMB 201.7 billion.

**VALUATION**

We don’t expect PetroChina to generate sufficient cash flows from its upstream business amid the weak crude pricing scenario. Sluggish oil production growth prospects and heavy exposure to significantly mature producing areas remain near-term headwinds as well, in our view. The company’s increasing operating cost is also a matter of concern.

These factors are reflected in our maintained Underperform recommendation on PetroChina ADRs.

PetroChina’s trailing 12-month P/CF multiple is 4.4 compared to the 4.9 average for the peer group and 15.3 for the S&P 500. The company’s trailing 12-month EV/EBITDA multiple is 4.3, compared to the industry average of 4.6.

Our $104 price objective reflects a multiple of 4.0 the trailing 12-month cash flow.
### Key Indicators

<table>
<thead>
<tr>
<th></th>
<th>P/E F1</th>
<th>P/E F2</th>
<th>Est. 5-Yr EPADR Gr%</th>
<th>P/CF (TTM)</th>
<th>P/E 5-Yr High (TTM)</th>
<th>P/E 5-Yr Low (TTM)</th>
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<td>S&amp;P 500</td>
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<td>Total SA (TOT)</td>
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<td>5.4</td>
<td>4.4</td>
<td>9.6</td>
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TTM is trailing 12 months; F1 is 2015 and F2 is 2016, CF is operating cash flow

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<th></th>
<th>P/B Last Qtr.</th>
<th>P/B 5-Yr High</th>
<th>P/B 5-Yr Low</th>
<th>ROE (TTM)</th>
<th>D/E Last Qtr.</th>
<th>Div Yield Last Qtr.</th>
<th>EV/EBITDA (TTM)</th>
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Earnings Surprise and Estimate Revision History

PETROCHINA ADR (A) Price
Price
EPS Surprises

PETROCHINA ADR (A)
Price
EPS ($/sh)
2015 Consensus
2014 Consensus
2013 Consensus
2012 Consensus
2011 Consensus
Price ($)

ZACKS
Investment Research

Equity Research

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Our recommendation for each stock is closely linked to the **Zacks Rank**, which results from a proprietary quantitative model using trends in earnings estimate revisions. This model is proven most effective for judging the timeliness of a stock over the next 1 to 3 months. The model assigns each stock a rank from 1 through 5. Zacks Rank 1 = Strong Buy. Zacks Rank 2 = Buy. Zacks Rank 3 = Hold. Zacks Rank 4 = Sell. Zacks Rank 5 = Strong Sell. We also provide a **Zacks Industry Rank** for each company which provides an idea of the near-term attractiveness of a company's industry group. We have 264 industry groups in total. Thus, the Zacks Industry Rank is a number between 1 and 264. In terms of investment attractiveness, the higher the rank the better. Historically, the top half of the industries has outperformed the general market. In determining the **Risk Level**, we rely on a proprietary quantitative model that divides the entire universe of stocks into five groups, based on each stock's historical price volatility. The first group has stocks with the lowest values and are deemed **Low Risk**, while the 5th group has the highest values and are designated **High Risk**. Designations of **Below-Average Risk**, **Average Risk**, and **Above-Average Risk** correspond to the second, third, and fourth groups of stocks, respectively.