

Headline	A better 2018 for power utilities
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# A better 2018 for power utilities

## Power utilities sector

**Maintain overweight.** Big cap Tenaga Nasional Bhd (TNB) (outperform; target price [TP]: RM17.17) finally had a better performance in 2017 with share price rising 12.45% while the Independent Power Producers (IPPs) performed poorly for another year as YTL Power International Bhd (market perform; TP: RM1.30) and Malakoff Corp Bhd (outperform; TP: RM1.25) saw their share prices contracting 9.16% and 28.96% respectively in 2017.

With the general election (GE14) around the corner and a new base tariff for the second regulatory period from January 2018 remaining unchanged at 38.53 sen/kWh. This is no surprise as the fuel costs will be adjusted by way of surcharge in the case of higher costs or rebate should actual fuel costs go lower than preference price.

Having said that, it remains earnings neutral to TNB, which also means that the integrated utility should warrant a higher price-earnings-ratio valuation as fuel risk is pass-through. Meanwhile, as the cut in capacity payments for Gen1 IPPs has already been reflected in the latest earnings, we believe the selling pressure on YTL Power and Malakoff should have abated. Thus, a better year for the sector in 2018.

We expect TNB's earnings to grow further on the back of 2.1% electricity demand growth in 2018, to be led by domestic and commercial segments, while YTL Power

## Power utilities sector peer comparison

NAME	PRICE @ 15-DEC-2017		MKT CAP (RM MIL)	PER (X)			NDIV. YLD. (%)	HISTORICAL ROE (%)	P/BV (X)	NET PROFIT (RM MIL)			CY17 NP GROWTH (%)	CY18 NP GROWTH (%)	TARGET PRICE (RM)	RATING
	(RM)	(RM MIL)		CY16	CY17	CY18				CY16	CY17	CY18				
Malakoff	0.93	4,624.4	13.0	15.4	15.3	4.5	5.7	0.8	355.46	299.73	301.66	-15.7	0.6	1.25	Outperform	
Pestech	1.65	1,261.1	16.9	15.3	14.6	2.0	25.5	3.1	74.55	82.65	86.41	10.9	4.6	2.00	Outperform	
Tenaga	15.42	87,369.5	13.3	14.1	13.0	3.1	12.6	1.5	6,553.63	6,197.82	6,730.07	-5.4	8.6	17.17	Outperform	
YTL POWR	1.29	10,226.0	13.4	13.3	11.4	3.9	5.1	0.8	765.20	766.55	894.54	0.2	16.7	1.30	Market Perform	

Source: Kenanga Research

should see a rebound in earnings as the Paka Power Plant recommenced in September last year after it resolved the dispute with TNB pertaining to a land issue.

Meanwhile, Malakoff's earnings are likely to be flattish given that upside is capped by a cut in Segari Energy Venture Sdn Bhd (SEV)'s capacity payment following the power purchase agreement (PPA) extension contract. Moving forward, operational efficiency is the key to determine TNB's bottom line as fuel cost risk is eliminated by the Imbalance Cost Pass Through (ICPT) mechanism.

TNB has indicated its keen interest in offshore expansion to drive earnings growth, although it does not expect to provide material impact anytime in the near future. On the other hand, YTL Power's dividend payout could be lower as it needs to conserve cash for two greenfield projects, namely PT Tanjung Jati coal-fired power plant in Indonesia and Attarat Power's oil shale-fired power plant in Jordan

over the next three to four years.

Meanwhile, Malakoff is still actively looking for offshore mergers and acquisitions (M&A) and greenfield opportunity to sustain earnings growth given the cut in SEV's capacity payments.

Elsewhere, Pestech International Bhd (outperform; TP: RM2) should see earnings growth on the back of its RM1.5 billion order book coupled with new contract flows to keep earnings momentum.

The government had agreed to subsidise RM929.4 million or 1.8 sen/kWh for first half of 2018 (1H18). This also means that there is no change in the new base tariff at 38.53 sen/kWh which started from Monday. This is against our expectation of a higher base tariff, given the rising fuel costs where the government already subsidised a total of 2.54 sen/kWh in 2H17.

We believe the maintaining of the new base tariff could be due to the upcoming GE14, which is due any time before August.

However, while the balance of

PPA savings fund of about RM40 million as of end-December is highly unlikely to be sufficient to net off the rising fuel costs; question remains on whether the government will allow TNB to raise tariff rates in the future.

Nonetheless, under the ICPT framework principle, fuel cost risk is passed through to end-consumers; thus, with neutral impact on TNB's earnings. In our view, we believe TNB will be allowed to continue passing through fuel cost risk to end-consumers in the future. As such, consumers are likely to pay for the surcharge should ICPT under-recovery situation persist in the future especially after GE14.

Despite relatively defensive earnings, the power utility sector is trading at undemanding valuations. This is fairly unwarranted, especially for TNB given its index-linked heavyweight status and earnings quality profile where the ICPT mechanism frees it from fuel cost movement risk.

Meanwhile, selling pressure on

Malakoff has somewhat abated and it is now trading at 41% discount to its sum-of-parts (SOP) valuations which appear to be attractive, in our view. We believe Malakoff could be a dark horse as in the stretched valuation in which we remove the problematic SEV, T4 power plant and all associate valuations, its SOP of RM1.08 per share is still higher than current price.

Besides, any M&A opportunity should boost sentiment. On the other hand, we are neutral on YTL Power as it is expected to distribute lower dividend payout at least in the next three to four years as it needs to conserve cash for two greenfield projects namely PT Tanjung Jati coal-fired power plant in Indonesia and Attarat Power's oil shale-fired power plant in Jordan.

Elsewhere, we continue to like alternative play Pestech for its earnings growth story as well expected maiden recurring income from the consensus asset Diamond Power starting this month. — Kenanga Research, Jan 3