Utilities

NEUTRAL

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Meter Swings to Low

By Teh Kian Yeong l tehky@kenanga.com.my

We remain lukewarm on the sector given limited growth prospects as earnings are regulated with lower rates of return trend for regulated assets for TENAGA, PETGAS and GASMSIA while IPPs are facing falling earnings with certain concession assets expiring soon. In addition, fears of fuel cost pass-through not working and the opening up of the industry continue to put pressure on the index-heavyweight further although we reckon that TENAGA is trading at an attractive level. Until such concerns are addressed, TENAGA is still MARKET PERFORM, at best. Nonetheless, we still believe the government is committed towards the ICPT mechanism. In all, we maintain our NEUTRAL rating on the Utilities Sector. However, PESTECH is still an alternative small cap play.

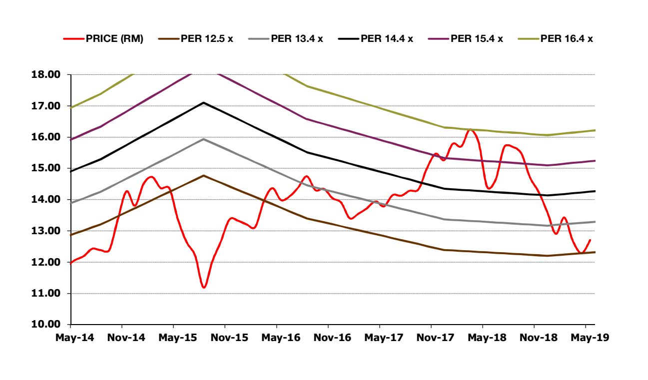
Weaker earnings in the coming quarters for TENAGA. Although it reported a strong set of 1Q19 earnings, which was not unexpected given seasonally lower opex and capex recognition, the remaining three quarters in FY19 are expected to be softer. In addition, **TENAGA (MP; TP: RM13.40)** is expected to book in a net negative c.RM300m impact in FY19 under MFRS16. Nonetheless, this has not changed management's PAT guidance of RM5.0b-RM5.4b which is in-line with our estimate. With a regulated asset return of 7.3%, TENAGA's earnings are set at this range for two years before a new set of tariff structure under Regulatory Period 3 (RP3) post 2020 is introduced. Besides, its ability to pass through higher fuel costs is a key test when the fund available in Kumpulan Wang Industri Elektrik (KWIE) to offset these higher costs is exhausted. Based on the fund amount of RM760m for KWIE in July 2018, the fund is likely to be exhausted by 1H20 should fuel costs remain high at the current level.

PETGAS to face base-tariff rate decline; lower margin spread for GASMSIA in RP2? PETGAS (MP; TP: RM16.55) posted a weaker 1Q19 core profit by 4% QoQ to RM457.8m which was well anticipated given the tariff cut under the Pilot Regulatory Period in 2019. It is crucial as tariff will be cut further when the official Regulatory Period 1 (RP1) starts next year. Its earnings will be impacted severely by two step-downs; in RP1 in 2020-2022 and Regulatory Period 2 (RP2) in 2023-2025, before stabilising from 2026 onwards. We take the view that its ROA will eventually taper to 8% by 2026 from >10% currently. Thus, we expect base-tariff for PGU to reduce sharply by 60% to RM0.502/GJ in 2026 from RM1.248/GJ in 2018 and earnings are set to decline by 21% over these periods. To recap, PETGAS had used optimised replacement cost in the past in contract to NBV for TENAGA and **GASMSIA (MP; TP: RM3.05)**, thus PETGAS posted superior ROA of above 10% as compared to 5%-6% for TENAGA and 8%-9% for GASMSIA. As such, the shift of valuation method of NBV will result in severe impacts as mentioned above. On the other hand, GASMSIA is in its final year of RP1 before the RP2 is introduced next year. Although gas selling price is trending upward with the subsidy removal every half-yearly, GASMSIA's earnings certainty is embedded under the Gas Cost Pass Through (GCPT) framework as its margin spread is capped at RM1.80-2.00/mmbtu based on regulated asset base return of 7.5%. However, judging from TENAGA's case, GASMSIA may see lower return of 7.3% in RP2 from 7.5%, which was exactly the case for TENAGA. This could reduce the margin spread to c.RM1.50-1.70/mmbtu and bring down our FY19/FY20 earnings estimates by 5% each and DCF valuation by RM0.20/share.

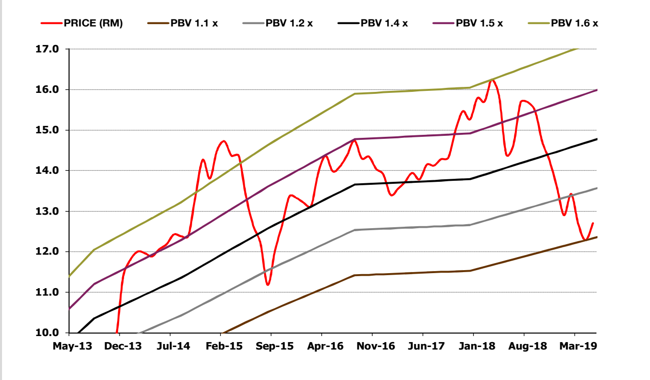
IPPs are still looking for new assets to fill up earnings gap. Share prices of IPPs, namely **YTLPOWR (MP; TP: RM0.88)** and **MALAKOF (MP; TP: RM1.00)** have been depressed in the past 2-3 years given their declining earnings trend on the back of capacity payment cuts arising from PPA Extension as well as difficult business condition for YTLPOWR's PowerSeraya and MALAKOF's faulty power plants. Not forgetting the PPA Extension for MALAKOF's PD Power that had already expired in February while the 2-year 10 months PPA Extension for YTLPOWR's Paka Power Plant will be expiring in mid-2021; all these will erode both IPPs' earnings further. In the latest 3Q19 results, YTLPOWR continued to see widening PowerSeraya's losses while MALAKOF's 1Q19 results were hit by high O&M costs sequentially. This may not augur well for the IPPs. As such, both companies are in urgency to fill up the near-term earnings gap. So far, YTLPOWR is expected to only see its two offshore greenfield power plants come into the system in 3-4 years' time while the MALAKOF's Alam Flora's acquisition is only set to be completed by year-end. As such, near-term earnings prospects for these two IPPs are lacklustre. Meanwhile, **PESTECH's (OP; TP: RM1.40)** 3Q19 results rebounded strongly by 83% sequentially on better progress claims after a lacklustre 1H19 owing to seasonality. We expect a strong finishing in 4Q19, especially for its Cambodian projects, which are in full-swing for the remainder of 2H19 before the raining season starts again in 1H20. Its forward earning growth is supported by RM1.8b order-book with new contract flows to sustain earnings momentum.

Lacklustre outlook; Maintain NEUTRAL. We had just downgraded TENAGA to MARKET PERFORM on Monday, following a solid 19% rally after we upgraded the stock to OUTPERFORM a month ago when the stock was sold down to new lows then, as we believe near-term positives should have been priced in. As earnings are regulated with a lower 7.3% return in RP2 and possibly even lower in RP3, there is limited earnings growth for TENAGA. This also applies to PETGAS and GASMSIA where their earnings are also regulated by the IBR. On the other hand, MALAKOF and YTLPOWR are still waiting for new earnings stream to fill up gaps as certain IPP concessions are running towards expiration. In addition, YTLPOWR is facing challenging business environment for PowerSeraya, which affects profitability. **We also downgraded MALAKOF to MARKET PERFORM with limited upside after the stock had risen 9% in the past one month.** On the flipside, PESTECH is expecting a strong finishing in 4Q19 on seasonality. Given the overall unexciting sector outlook, we maintain our NEUTRAL rating on the sector while PESTECH is still an alternative small cap play.

TENAGA: Fwd Core PER

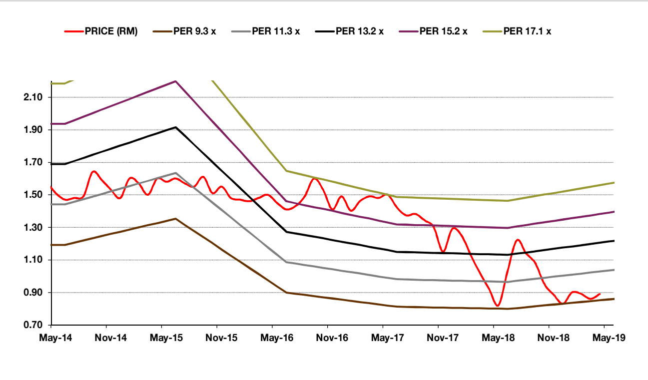


TENAGA: Fwd PBV

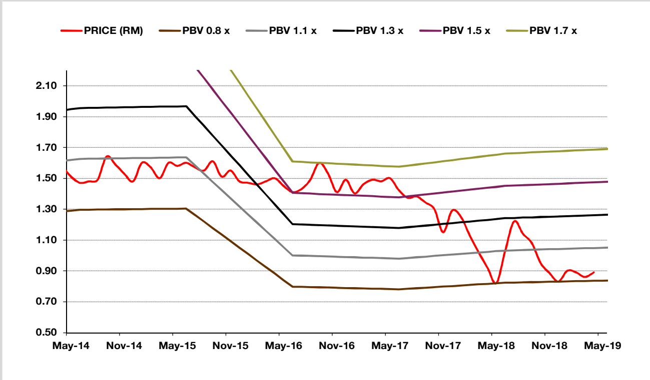


Source: Kenanga Research

YTLPOWR: Fwd Core PER

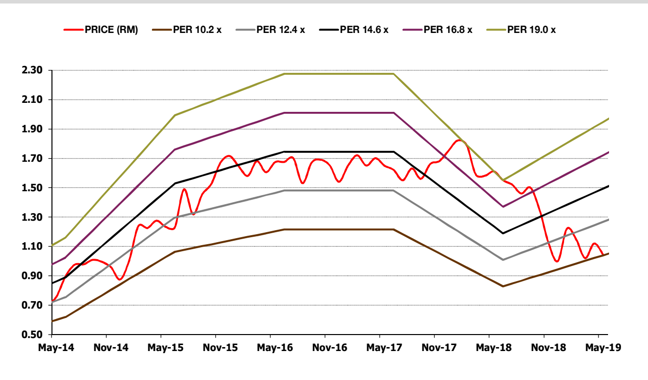


YTLPOWR: Fwd PBV

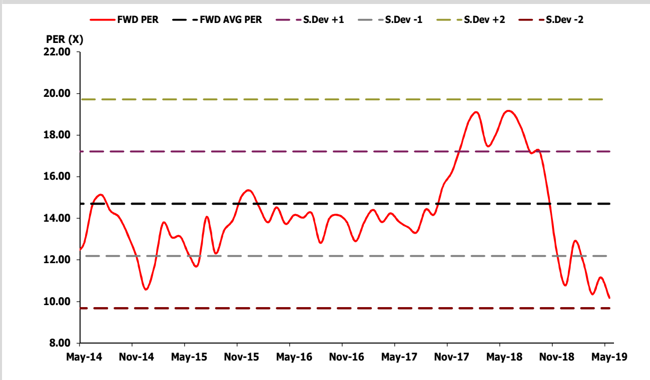


Source: Kenanga Research

PESTECH: Fwd Core PER

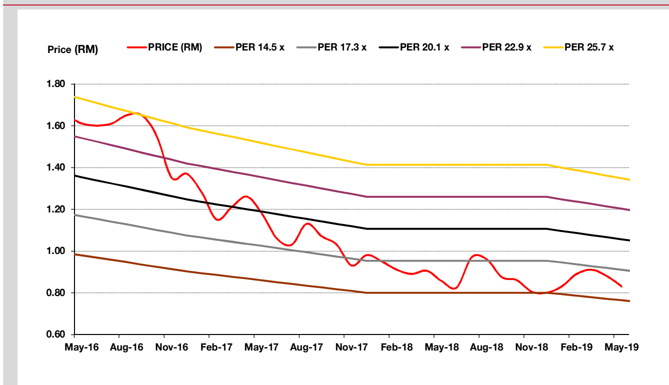


PESTECH: Fwd PER Std Dev

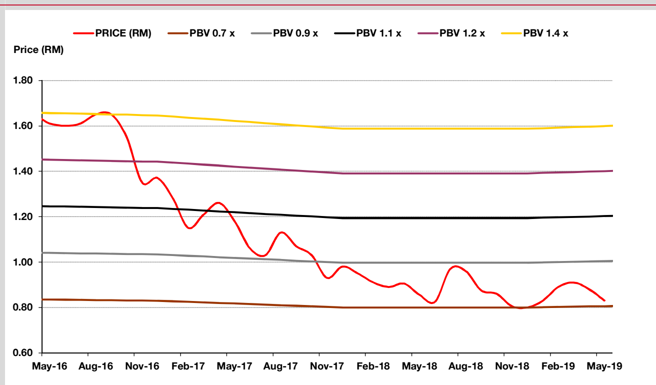


Source: Kenanga Research

MALAKOF: Fwd PER

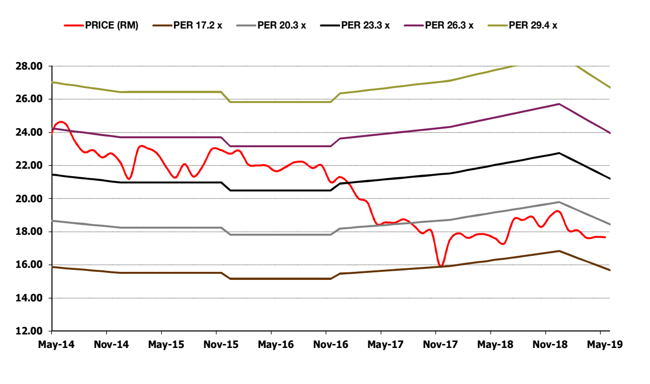


MALAKOF: Fwd PBV

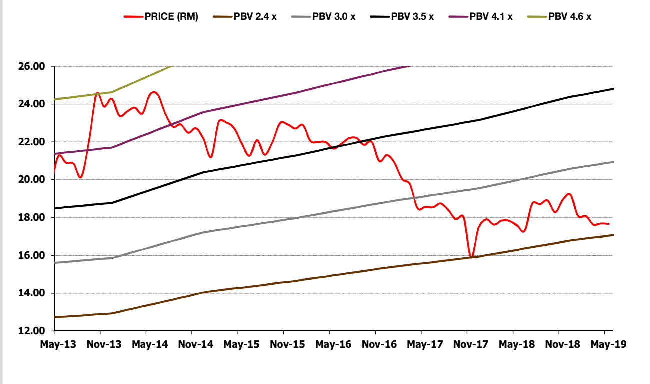


Source: Kenanga Research

PETGAS: Fwd PER

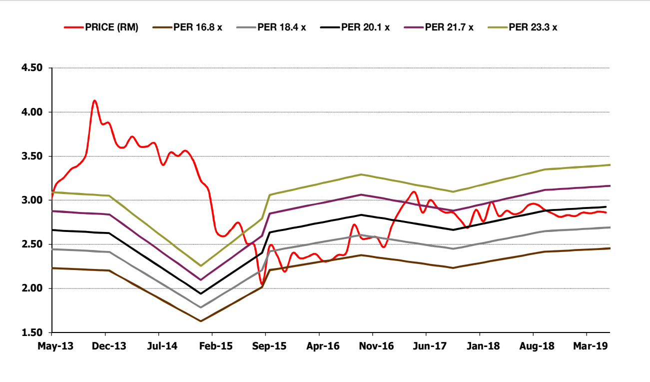


PETGAS: Fwd PBV

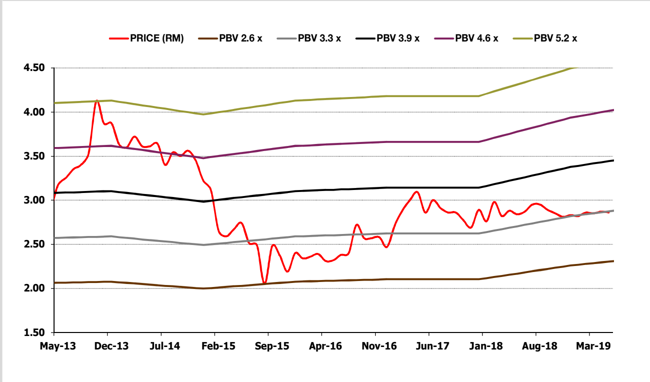


Source: Kenanga Research

GASMSIA: Fwd PER



GASMSIA: Fwd PBV



Source: Kenanga Research

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Peer Comparison

Name	Price @ 21 June 2019 (RM)	Market Cap (RM'm)	Shariah Compliant	Current FYE	Revenue Growth 1-Yr. Fwd.	Revenue Growth 2-Yr. Fwd.	Core Earnings Growth 1-Yr. Fwd.	Core Earnings Growth 2-Yr. Fwd.	PER (x) - Core Earnings Hist.	PER (x) - Core Earnings 1-Yr. Fwd.	PER (x) - Core Earnings 2-Yr. Fwd.	PBV (x) Hist.	PBV (x) 1-Yr. Fwd.	ROE (%) 1-Yr. Fwd.	Net Div.Yld. (%) 1-Yr. Fwd.	Target Price (RM)	Rating
GAS MALAYSIA BHD	2.88	3,697.9	Y	12/2019	2.9%	7.7%	8.2%	2.2%	21.1	19.5	19.1	3.5	3.2	17.3%	3.8%	3.05	MP
MALAKOFF CORP BHD	0.920	4,496.8	Y	12/2019	-0.3%	-0.1%	11.0%	4.1%	21.0	18.9	18.2	0.8	0.8	4.3%	4.2%	1.00	MP
PESTECH INTERNATIONAL BHD	1.11	848.4	Y	06/2019	6.7%	22.2%	28.0%	30.9%	13.6	10.7	8.1	1.9	1.6	16.0%	0.0%	1.40	OP
PETRONAS GAS BHD	17.86	35,340.2	Y	12/2019	4.8%	-1.8%	5.7%	-14.7%	19.4	18.3	21.5	2.7	2.6	14.5%	3.8%	16.55	MP
TENAGA NASIONAL BHD	12.88	73,247.1	Y	11/2020	3.2%	1.8%	2.6%	2.0%	13.4	13.1	12.8	1.3	1.2	9.3%	3.1%	13.40	MP
YTL POWER INTERNATIONAL BHD	0.845	6,485.6	N	06/2019	3.4%	2.6%	-1.6%	8.0%	9.7	9.9	9.1	0.5	0.4	4.6%	5.9%	0.880	MP
Simple Average					**3.4%**	**5.4%**	**9.0%**	**5.4%**	**16.4**	**15.1**	**14.8**	**1.8**	**1.6**	**11.0%**	**3.5%**		

Source: Bloomberg, Kenanga Research

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Stock Ratings are defined as follows:

Stock Recommendations

OUTPERFORM	: A particular stock's Expected Total Return is MORE than 10%
MARKET PERFORM	: A particular stock's Expected Total Return is WITHIN the range of -5% to 10%
UNDERPERFORM	: A particular stock's Expected Total Return is LESS than -5%

Sector Recommendations***

OVERWEIGHT	: A particular sector's Expected Total Return is MORE than 10%
NEUTRAL	: A particular sector's Expected Total Return is WITHIN the range of -5% to 10%
UNDERWEIGHT	: A particular sector's Expected Total Return is LESS than -5%

******Sector recommendations are defined based on market capitalisation weighted average expected total return for stocks under our coverage.***

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