Utilities

Meter Stays Low

NEUTRAL

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We remain NEUTRAL on the Utilities Sector given the limited growth prospects as earnings are regulated with lower rates of return for regulated assets impacting TENAGA, PETGAS and GASMSIA while IPPs are faced with falling earnings with certain concession assets expiring soon but burdened without near-term new earnings stream to bridge the earnings gap. Nonetheless, the recently revealed MESI 2.0's key reform initiatives have offered a better clarity which should remove concerns of TENAGA losing its entire monopoly status which it may not be the case for the T&D segment. Also, TENAGA and IPPs are allowed to benefit from open fuel sourcing arbitrage, if managed efficiently. In all, we are neutral on the sector with PESTECH touted as an alternative small-cap play.

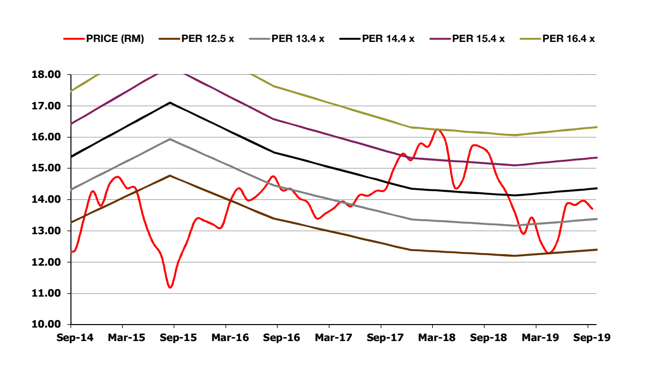
MESI 2.0 reform initiatives revealed. In mid-Sep, the Cabinet approved a 10-year master plan called Malaysia Electricity Supply Industry 2.0 (MESI 2.0) to reform the domestic power industry. While details are yet to be ironed out, the Minister has revealed four key reform initiatives such as: (i) allowing generators like IPPs to source own fuel to optimise cost; (ii) moving from PPA regime to capacity and energy market; (iii) establishing third party access (TPA) framework and network charges for grid to allow third party using the infrastructures; and (iv) facilitating green energy producers and consumers. The measure to allow generators, including **TENAGA (MP; TP: RM13.40)** and IPPs to source for own fuel is something new especially for the IPPs as they will take on risk in looking for fuel sourcing and procurement, and any resultant savings will be shared between customers and IPP. Currently fuel sources are secured by TENAGA and it is pass-through under ICPT. The opening up of fuel sourcing is targeted to have a trial pilot period in 1Q21 with full roll-out in 2Q21.

IPPs are open to fuel cost risk in the future. With IPP having options to procure their own fuels, there is no more risk-free PPA. However, this is an incentive for IPPs to optimise cost as any savings will flow down to bottomline. Nonetheless, this has little impact on **YTLPOWR (OP; TP: RM0.82)** as the PPA Extension contract for the 585MW Paka Power Plant will be expiring on 30 Jun 2021 which will have only six months effect when this new measure take place in early 2021. However, this will impact **MALAKOF (OP; TP: RM1.00)** more as the two major IPPs namely TBP and TBE still have another 10-20 years concession period. Having said that, in theory, IPPs could benefit as long as they are able to secure cheap fuel costs but practically, a bargain purchase requires bulk purchase with sizeable quantity which may proof difficult. Therefore, in our opinion, this new measure does offer margin accretion if managed efficiently but also acts as a double-edged sword if it is badly managed. In any case, we believe at this point of time, both listed IPPs should put their focus on new assets to fill up their earnings gap 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 plus 10-month PPA Extension for YTLPOWR's Paka Power Plant will be expiring in mid-2021; all these will erode both IPPs' earnings further. So far, MALAKOF had participated in the 500MW Large Scale Solar 3 (LSS3) project where the bidding submission has ended on 19 Aug while TENAGA and **PESTECH (OP; TP: RM1.75)** also took part in the bidding.

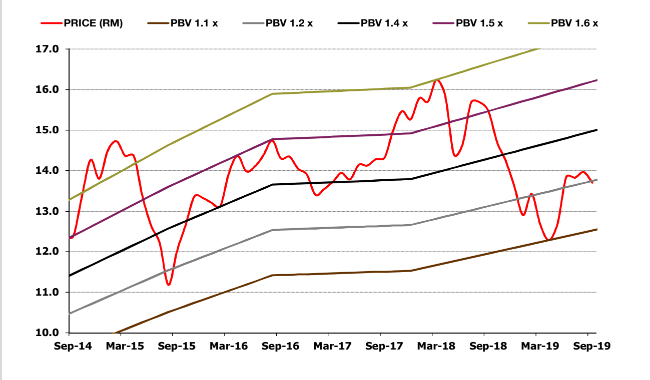
PETGAS and GASMSIA are waiting for new RPs to start in 2020. Share price of **PETGAS (MP; TP: RM15.75)** has been suppressed in the past two years given the fear of severe tariff cut when the official Regulatory Period (RP) 1 starts next year as the current Pilot RP in 2019 already saw its Gas Transportation earnings weakening by 21% or 14% decline in topline in 1H19. Therefore, It is crucial as tariff will be cut further when the official 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. On the other hand, **GASMSIA (MP; TP: RM3.00)** 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-year, 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 FY19/FY20 earnings estimates by 5% each and DCF valuation by RM0.20/share.

Outlook still lacklustre; Maintain NEUTRAL. There is lack of factors to be upbeat about the sector given that MESI 2.0 is neutral for TENAGA although it has set out clearer guideline for the sector. In addition, the integrated utility is facing a seasonally weaker 2H which may not augur well for sentiment. On the other hand, lack of new near-term earnings stream to bridge gap is also depressing sentiment towards IPPs. Furthermore, PETGAS and GASMSIA are in the uncertain stage of facing new RPs next year. Lastly, PESTECH is also entering seasonally weaker quarters after a strong 4Q19. Given the overall unexciting sector outlook, we maintain our NEUTRAL stand on the Utilities Sector but PESTECH is still our alternative small-cap play.

TENAGA: Fwd Core PER

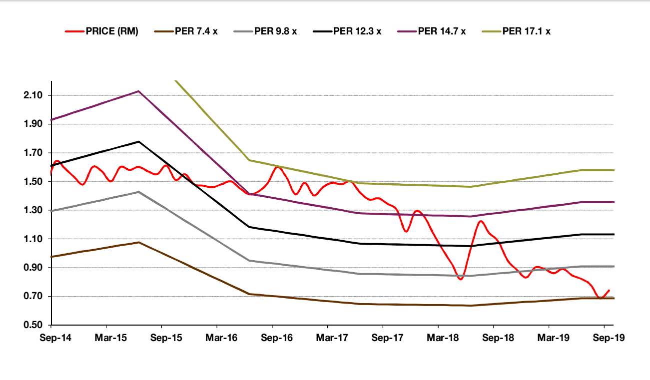


TENAGA: Fwd PBV



Source: Kenanga Research

YTLPOWR: Fwd Core PER



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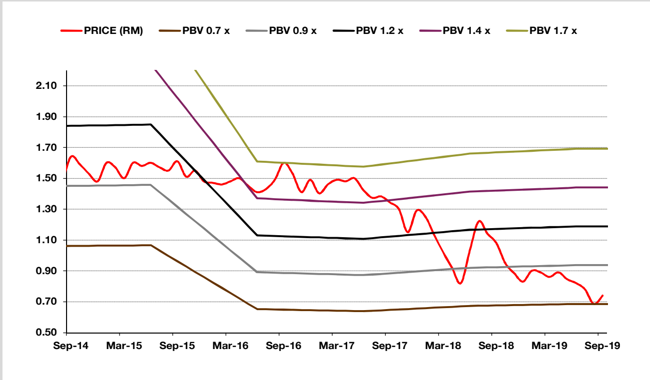
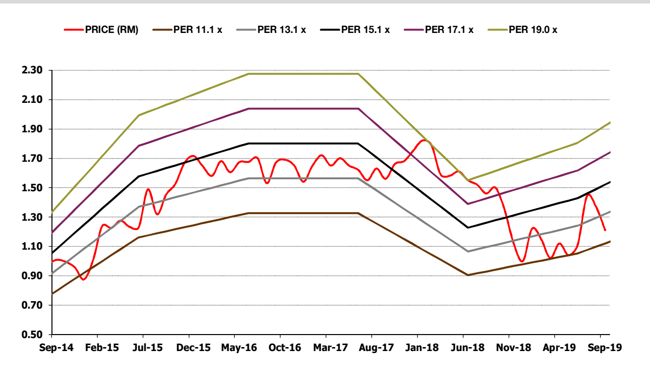
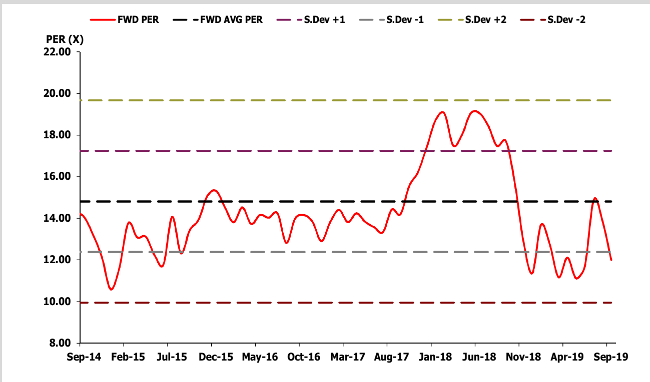


Source: Kenanga Research

PESTECH: Fwd Core PER

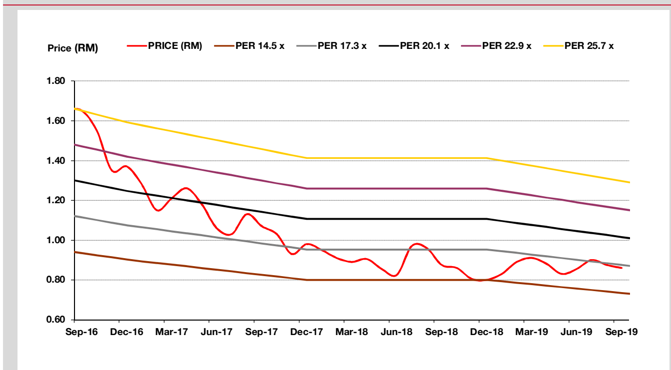


PESTECH: Fwd PER Std Dev

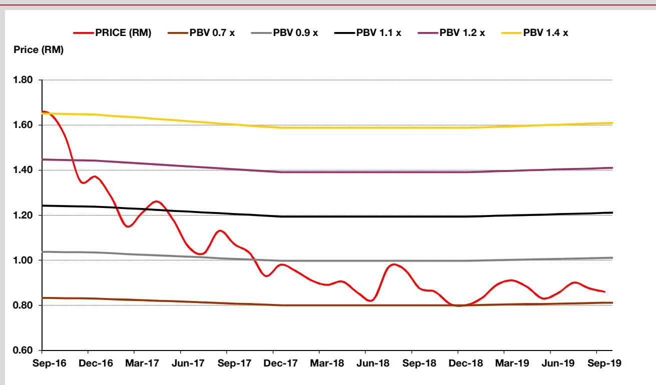


Source: Kenanga Research

MALAKOF: Fwd PER

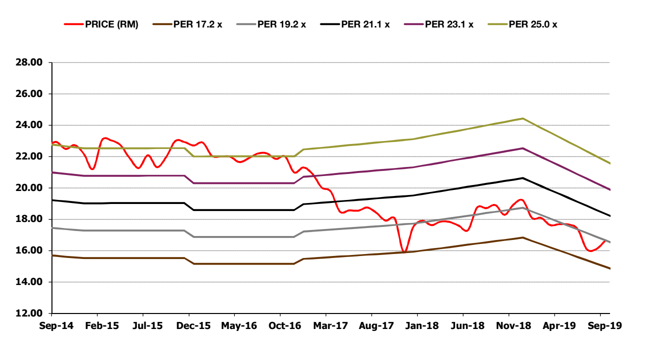


MALAKOF: Fwd PBV

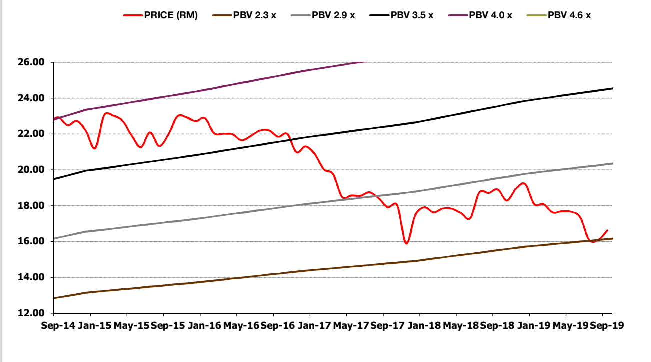


Source: Kenanga Research

PETGAS: Fwd PER

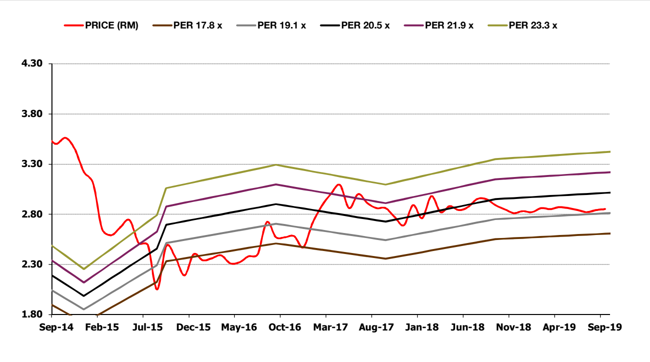


PETGAS: Fwd PBV



Source: Kenanga Research

GASMSIA: Fwd PER



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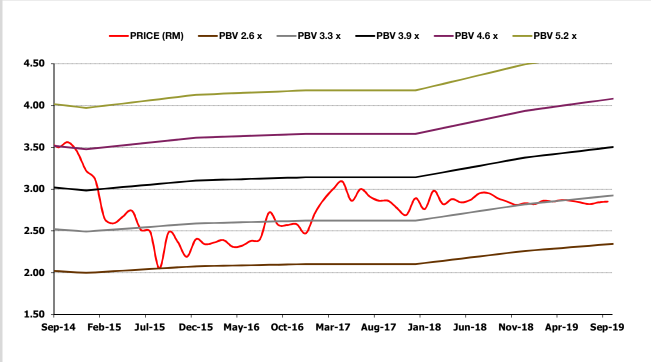

Source: Kenanga Research

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Peer Comparison

Name	Price @ 20 Sep 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	2.85	3,659.4	Y	12/2019	2.9%	7.7%	8.2%	2.2%	21.5	19.9	19.5	3.6	3.3	17.3%	4.5%	3.00	MP
MALAKOFF CORP BHD	0.860	4,202.8	Y	12/2019	-0.3%	-0.1%	10.5%	4.5%	19.6	17.7	17.0	0.8	0.8	4.3%	4.5%	1.00	OP
PESTECH INTERNATIONAL BHD	1.21	924.8	Y	06/2020	17.3%	10.5%	25.8%	13.5%	12.8	10.2	8.9	2.0	1.7	18.3%	0.0%	1.75	OP
PETRONAS GAS BHD	16.62	32,886.5	Y	12/2019	4.8%	-1.8%	5.7%	-14.7%	18.0	17.0	20.0	2.5	2.4	14.5%	4.1%	15.75	MP
TENAGA NASIONAL BHD	13.70	77,910.4	Y	12/2019	3.2%	1.8%	2.6%	2.0%	14.3	13.9	13.6	1.3	1.3	9.3%	3.6%	13.40	MP
YTL POWER INTERNATIONAL BHD	0.735	5,641.3	N	06/2020	-3.9%	2.2%	8.0%	0.6%	8.6	8.0	7.9	0.4	0.4	5.0%	6.8%	0.820	OP
Simple Average					**4.0%**	**3.4%**	**10.1%**	**1.3%**	**15.8**	**14.4**	**14.5**	**1.8**	**1.6**	**11.4%**	**3.9%**		

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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