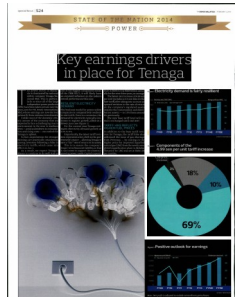


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# Key earnings drivers in place for Tenaga

The power sector in Malaysia is dominated by national utility company Tenaga Nasional Bhd. This is particularly so since all of the large independent power producers (IPPs) have been taken private over the years, save for YTL Power International Bhd, whose earnings are now derived primarily from overseas investments.

Unlike most of the domestic-centric sectors of the economy that are expected to face a challenging macro environment in the near to medium term — amid a slowdown in consumption and rising costs — our outlook for Tenaga is upbeat.

In fact, expectations for stronger earnings are practically unanimous among investors following a hike in electricity tariffs, which came into effect on Jan 1.

As a result, we expect Tenaga's shares to continue to do well. And as one of the biggest component stocks of the FBM KLCI, it will likely have an outsized influence on the index's overall performance this year.

## RESILIENT ELECTRICITY DEMAND

The business model for power utility companies is comparatively resilient to start with. Even in a recession, the demand for electricity typically continues to register growth, albeit at a slower pace (see Figure 1).

For the current year, Tenaga estimates electricity demand growth at 3.5% to 4%.

Importantly, the latest tariff revision represents a key shift in the government's stance — allowing Tenaga to earn a "fair" rate of return on its assets.

This is to ensure the company's longer-term financial viability, so that it can invest to support the country's growing power needs. Capital expenditure is likely to top RM8 billion annually for the next three years, on average.

The latest rate increase of 4.99 sen per unit includes a 0.9 sen hike in the base tariff, after taking into account an upward revision in the rate of return

on the company's regulated assets (mainly the transmission and distribution assets) — to 7.5% from around 6% previously.

The new base tariff level will remain unchanged until end-2017.

## TARIFF HIKE REFLECTS HIGHER FUEL PRICES

In addition to the base tariff revision for Tenaga, the tariff hike also addressed the issue of gas shortage from Petronas — by costing in the higher price for imported liquefied natural gas (LNG) from the newly completed regasification plant in Melaka. The price for LNG was set at RM41.68 per mmbtu.

Recall that power producers (Tenaga and some IPPs) were forced to run on alternative fuels, mainly distillate and oil, owing to gas outages through 2011-2013. This resulted in substantially higher fuel costs, which were borne equally by Tenaga, Petronas and the government.

Additionally, as part of the government's subsidy rationalisation plan, the price of gas from Petronas was raised from RM13.70 per mmbtu to RM15.20 per mmbtu. There was also a slight upward adjustment for the price of coal, to US\$87.50 per tonne.

In all, higher fuel costs — for gas, LNG and coal — accounted for the largest slice, some 82%, of the 4.99 sen per unit tariff hike (see Figure 2).

## FUEL COST PASS-THROUGH MECHANISM — REVIEW EVERY SIX MONTHS

As things stand, the Energy Commission, the regulator for the energy industry, is to review Tenaga's actual fuel costs every six months. Any variation will be reflected as an adjustment (upwards or downwards) to the current tariff levels.

For instance, the government may continue to cut back on subsidies for gas. If this happens, the tariff rate will be adjusted up to pass on the higher costs.

In short, any tariff increase/decrease from here on should be earnings-neutral for Tenaga.

## STABLE COAL-PRICE FORECASTS BODE WELL FOR TENAGA

One of the biggest risk factors that would derail our rosy outlook for Tenaga is the price of coal.

Coal is used in the generation of some 45% of total electricity in the country.

The government controls the price of gas. Hence, the timing of any cost increase can be managed. But the price of imported coal is market-driven.

Although the fuel cost pass-through mechanism should insulate Tenaga from volatility in fuel costs, in reality, approval for any tariff adjustment still has to come from the government. Thus, there always exists the risk of an extended lag before tariffs reflect the actual costs.

Fortunately, thermal coal prices have fallen well off their peak — which averaged as high as US\$142 a tonne in January 2011 — and are currently selling for around US\$85 a tonne.

Market consensus expects a slight oversupply situation to prevail through the year, which would keep prices on a fairly even keel. Most forecasts have prices ranging from US\$80 to US\$90 a tonne. Stable fuel costs would bode well for Tenaga.

## IN CONCLUSION, KEY EARNINGS DRIVERS IN PLACE


In summary, all of the above-mentioned factors — higher base tariff, resilient electricity demand, absence of "higher-than-normal" fuel costs owing to gas shortage, and the fuel cost pass-through

mechanism — will be the key drivers for Tenaga's earnings going forward.

Research outfit InsiderAsia forecasts Tenaga's net profit will rise to more than RM4.6 billion for the current financial year ending August and RM5.6 billion in FY2015, up from RM4.12 billion in FY2013, excluding unrealised forex gains/losses (see Figure 3).

## PROSPECTS FOR EARNINGS AND DIVIDENDS GROWTH

This means the stock is trading at only 14.1 and 11.5 times estimated earnings for FY2014 and FY2015, respectively, at the current share price of RM11.50 — making it one of the cheapest large-capitalised stocks on the local bourse. It also prices Tenaga below the average valuations for the broader market, currently estimated at 17 to 18 times forward earnings.

In line with the stronger earnings, InsiderAsia also expects higher dividends for shareholders, assuming a similar profit payout ratio as the previous year. Dividends are estimated to total 30 and 36 sen a share in FY2014 and FY2015, respectively. This will earn shareholders fairly decent net yields of 2.6% to 3.1%. 

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Figure 1 Electricity demand is fairly resilient

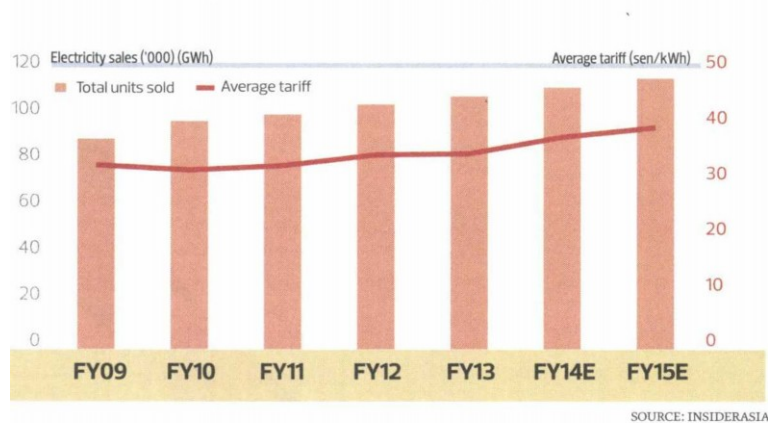


Figure 2 Components of the 4.99 sen per unit tariff increase

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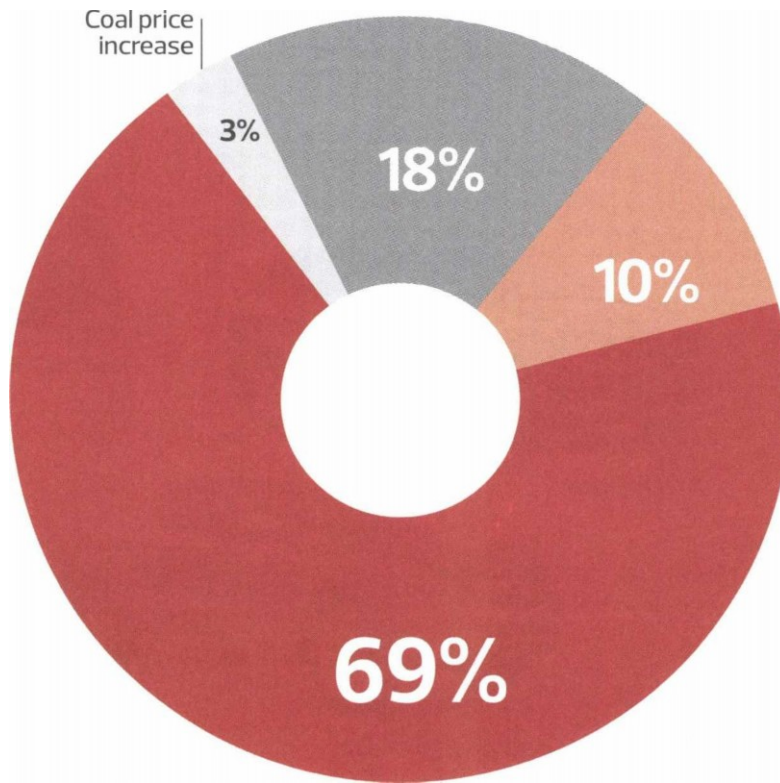
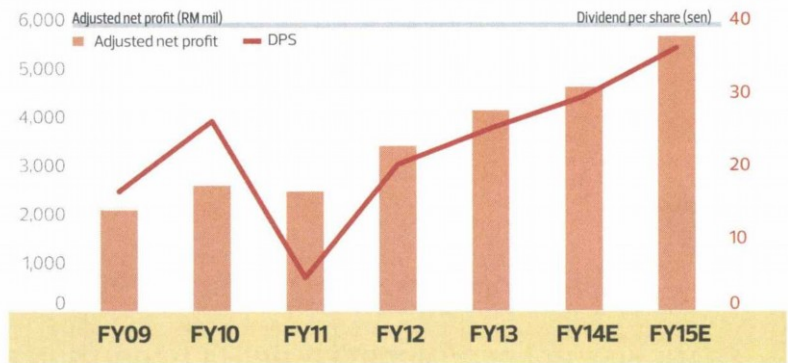


Figure 3 **Positive outlook for earnings**



SOURCE: INSIDERASIA

Note: Net profit is adjusted to exclude extraordinary gains/losses

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