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03 July 2017 | Sector Update

Power Sector

***Maintain* POSITIVE**

Worst case scenario priced in?

INVESTMENT HIGHLIGHTS

- **Government to foot higher electricity bills for 2H17**
- **ICPT effectively turned into surcharge, adjustments likely in 2nd IBR period**
- **Market looks to have factored in "worst case" scenario for upcoming IBR review**
- **Maintain POSITIVE on Power. Top pick is Tenaga (BUY, TP: RM16.80/share)**

Government to foot higher tariffs. Tenaga announced that the ICPT rebate for the 2HCY17 period will remain at 1.52sen, though in reality, given the increase in fuel price and the weaker Ringgit in 1HCY17, the ICPT should have rightfully turned into a surcharge of 1.02sen/kwh. The difference, which equals to an absolute amount of RM1.3b, will be borne by the Government by utilising its PPA savings fund (these are savings accumulated from the renewal of 1st generation PPAs at lower rates). This therefore, should provide a buffer to Tenaga's cost in 2H17 after the cost pressure seen in 1H17. To recap, earnings in 1H17, though within expectations, were impacted by higher fuel cost. Though technically Tenaga gets to pass through any volatility in fuel and forex, there is a 6-months lag as the ICPT (the mechanism allowing for fuel cost volatilities to be reflected in tariffs) is only reviewed every 6 months, which causes short term volatilities in margins.

EXHIBIT 1: TENAGA COMPENSATED FOR VARIANCE VS. IBR ASSUMPTIONS VIA ICPT

1st IBR Period Fuel Price assumptions (2014-2017)	Unit cost	Current price
Piped Gas (RM/mmbtu) up to a maximum of 1000 mmscfd	15.20	22.70
Coal (USD/tonne) (CIF) (CV:5500kcal/kg)	87.50	66.00
LNG (RM/mmbtu)	41.68	25.99
USD:RM	3.14	4.29

Source: EC, MIDFR

Cost pressure is easing. Fortunately, **c**oal price has also eased in the past month to ~USD60/mt vs. the USD70/mt levels seen since Mar17. Additionally, the Ringgit, at USD:RM4.27, has also strengthened quite significantly against the trough of USD:RM4.48 seen early this year. This should work to ease the generation cost pressure that Tenaga has experienced in the past few quarters, on top of the buffer from utilisation of PPA savings in the next 6 months.

PPA savings depleted. The PPA savings used by the Government to foot the higher electricity bill is just sufficient for the 2H17 period. With the RM1.3b to be spent in 2HCY17, the Government would run down the bulk of the RM1.4b PPA savings fund. The PPA savings funds had been used in the past to minimise tariff volatilities for consumers but the RM1.3b is one of the largest chunk used in a single period given the sharp swing in fuel cost. Nonetheless the current (1st) IBR period running from 2014 to 2017 will be reaching an end towards Dec17, coinciding with the end of the current ICPT period. Moving into the 2nd IBR period (2018-2020) the base tariff of 38.5sen/kwh itself will be reviewed. Other than determining new allowable ROAs and the regulated asset base in the 2nd IBR period, the regulators are also likely to factor in the higher fuel price and Ringgit levels now compared to assumptions in the 1st IBR period (See Exhibit 3).

Recap of the IBR allowable returns. Tenaga's T&D (transmission & distribution) unit is regulated due to its monopoly. A key component of the IBR framework is the ROA that Tenaga is allowed on these regulated assets for each regulatory period. To achieve this allowed ROA (and ultimately, the revenue requirements for Tenaga), Tenaga's base tariffs are set to a certain level for that period e.g. in the current IBR period, base tariffs are set at 38.5sen/kwh based on 7.5% allowable ROA on the regulated T&D assets. Of course there are other cost pass-through components such as fuel & generation cost, tax and depreciation, among others, which affect the determination of the base tariff, but the allowable ROA accounts for a big chunk of this and is essentially the profit element for Tenaga from its T&D operations.

EXHIBIT 2: TENAGA REVENUE REQUIREMENT WHICH FORMS BASE TARIFF OF 38.53 SEN/KWH

TNB Revenue Requirement for current IBR period (2014-2017)	(RMm)	Demand assumption (GWH)	Base tariff (sen/kwh)
Single buyer revenue requirement	116,273		
System operation requirement	201		
Single buyer operation requirement	849		
Transmission revenue requirement	16,187		
Distribution revenue requirement	36,543		
Total	**170,054**	**441,354**	**38.53**
of which (2014-2017) (RMm):			
1) Transmission revenue requirement			
ROA	*6,706*		
Depreciation	4,216		
OPEX	3,545		
Regulatory tax	1,720		
Total	**16,187**		
2) Distribution revenue requirement			
ROA	*6,692*		
Depreciation	9,233		
OPEX	19,361		
Regulatory tax	1,257		
Total	**36,543**		

Source: EC, MIDFR

EXHIBIT 3: ALLOWABLE ROA DETERMINATION IN 1ST IBR PERIOD

Regulatory WACC for TNB Under IBR (FY2014-2017) is 7.5%

WACC Parameters	Actual market Parameters	TNB's Proposal	Recommendation
Stock $_{TNB}$ Beta	0.92[1]	1.435	1.435 [4]
Market Return (R_m)	8.8%[2]	12.3%	8.8%
Risk free (R_f)	4.0%	4.0%	4.0%
Market Risk Premium (R_m - R_f)	4.8%	8.3%	4.8%
Debt Margin (D_m)	2.19%	2.24%	2.24%
Tax Rate	25.0%	25.0%	25.0%

Weighted Cost of Capital Calculation

	Actual market Parameters			TNB's Proposal			Recommendation		
Capital Structure	Cost	Capital Structure	Weighted Cost	Cost	Capital Structure	Weighted Cost	Cost	Capital Structure	Weighted Cost
Cost of Equity (K_e)	8.38%	60.5%	5.1%	15.91%	45.0%	7.16%	10.85%	45.0%	4.88%
Cost of Borrowing (K_d)[3]	6.18%	39.5%	1.8%	6.24%	55.0%	2.57%	6.24%	55.0%	2.57%
Weighted Cost of Capital			6.9%			9.7%			7.5%

Note:
[1] Based on beta for the period 2004-2012
[2] R_m - Market return of 10 yrs KLSE Index
[3] Average Gearing (2004-2011) is 39.5%
[4] Adjusted to reflect optimal gearing

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Source: EC, MIDFR

Has the market factored in a worst case scenario? A concern weighing down on Tenaga's share price is risk of a reduction in allowable ROA for the 2nd IBR period given the large discrepancy between Tenaga's recommendations on cost of equity (Ce) vs. the regulator's in determining allowable ROAs in the 1st IBR period. Nonetheless, we think current price levels have more than reflected this risk. In a worst case scenario where allowable returns are reduced to 6.5% from the current 7.5%, we estimate a ~RM485m/annum, or 7%-8% impact to Tenaga's bottomline; our TP falls to RM15.40/share (from RM16.80/share currently) if we factor in this "worst case" scenario, which still entails meaningful upside against the depressed RM14.20/share levels Tenaga is trading at currently.

EXHIBIT 4: TENAGA TP SENSITIVITY TO CHANGE IN ALLOWABLE ROA

	Current ROA				***Worst case***
Regulated asset ROA	***7.50%***	7.25%	7.00%	6.75%	***6.50%***
Target Price (RM/share)	***16.80***	16.40	16.10	15.70	***15.40***
Current price (RM/share)	**14.14**	14.14	14.14	14.14	**14.14**
Upside vs. current share price	**18.8%**	16.0%	13.9%	11.0%	**8.9%**

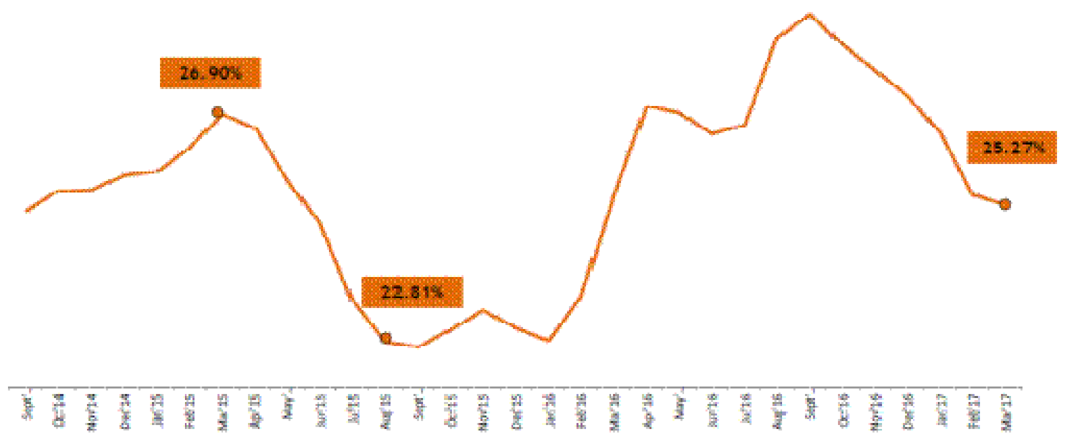
Source: EC, MIDFR

Cheap, liquid play into upcycle in trade and GDP numbers. Our in house economics team has upgraded our trade and GDP forecast (FY17F) i.e. GDP growth from 4.8% to 5.1% now. Consensus generally has seen numerous upward revisions to macro forecasts in the past 6 months. The power sector, via Tenaga, is a cheap and liquid play into this upcycle. Tenaga has been lagging the market rebound since early this year, trading at just 12x FY18F earnings relative to market valuation of 16x-17x.

Key sector catalysts: (1) Players are sitting on underutilized balance sheets, particularly Tenaga. Key catalyst is an expansion in dividend payout, (2) Regional expansion on the cards for players i.e. Tenaga is on the lookout for regional opportunities after having acquired GMR Energy (India) and GAMA Enerji (Turkey) in the past 18months while YTL Power's expansion of its overseas operations via Tanjung Jati (Indonesia) and Attarat (Jordan), due for operations in FY21F, bodes well due to diminishing returns in Malaysian power generation. YTL Power is estimated to generate 15% and 19% equity IRR from Tanjung Jati and Attarat respectively vs. single digit returns domestically (3) The thrust in renewable energy capacity, in particular, large scale solar, will benefit the smaller players such as Cypark Resources (NOT-RATED).

Foreign shareholding is close to trough. As of March 2017, Tenaga's foreign shareholding stood at 25.27%, close to its 2-year trough of 22.8% and versus a high of ~27%.

EXHIBIT 5: TENAGA'S FOREIGN SHAREHOLDING HAS REDUCED MARKEDLY



Source: Company, MIDFR

We maintain POSITIVE on the power sector. Tenaga (BUY, TP: RM16.80) remains our top sector pick. Key catalysts: (1) Dividend catalyst on the back of an under-geared balance sheet and capital optimisation exercise (2) Overseas expansion provides scope for stronger growth in the mid-term (3) Strong earnings visibility post-ICPT implementation (4) At just 12x FY18F PE Tenaga trades at a discount to sector average of 13x and the index's 16x-17x. Tenaga is a liquid proxy to the GDP growth and trade upcycle, but share price has yet to move meaningfully relative to the broader market. YTL Power (TP: RM1.56/share) remains a NEUTRAL as earnings drag from its Singapore operations is likely to persist.

VALUATION AND RECOMMENDATION

		Shr Price	EPS (sen)		PE (x)		Div Yield	Target
Companies	**Rating**	**(RM)**	**FY16F**	**FY17F**	**FY16F**	**FY17F**	**(%)**	**Price (RM)**
Tenaga	Buy	14.14	126.7	118.9	11.2	11.9	4.0	16.80
YTL Power	Neutral	1.45	8.8	10.8	16.4	13.4	6.0	1.56

Source: Bloomberg, Companies, MIDFR

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MIDF AMANAH INVESTMENT BANK : GUIDE TO RECOMMENDATIONS	
STOCK RECOMMENDATIONS	
BUY	Total return is expected to be >15% over the next 12 months.
TRADING BUY	Stock price is expected to *rise* by >15% within 3-months after a Trading Buy rating has been assigned due to positive newsflow.
NEUTRAL	Total return is expected to be between -15% and +15% over the next 12 months.
SELL	Total return is expected to be <-15% over the next 12 months.
TRADING SELL	Stock price is expected to *fall* by >15% within 3-months after a Trading Sell rating has been assigned due to negative newsflow.
SECTOR RECOMMENDATIONS	
POSITIVE	The sector is expected to outperform the overall market over the next 12 months.
NEUTRAL	The sector is to perform in line with the overall market over the next 12 months.
NEGATIVE	The sector is expected to underperform the overall market over the next 12 months.