

19 October 2018 | Sector Update

Utilities – Water

Maintain POSITIVE

11th Malaysia Plan Mid-Term Review Takeaways

Part I: Past Performance (2016-2017):

- Non-Revenue Water (NRW): 35.2% (2016) 25% (2020 target)
- Sewerage connected services 67.9% (2016) 80% (2020 target)
- Population served by clean and treated water 95.7% (2016) 99% (2020 target)
- Water sector in Kelantan migrated to new licensing regime joining an earlier 6 states that have migrated
- Joint-billing in Labuan has shown improvement in collection of sewerage charges by 33.4%
- Upgrade of 4 existing water treatment plants has increased production capacity by 221MLD
- Implemented holistic NRW program in 2017 aimed to reduce NRW to 25% by 2020
- Completion of 181 public sewerage treatment plants has improved coverage of sewerage services

Part II: Issues and challenges:

- High NRW levels remains a challenge – revenue loss financially impacts the ability to maintain water assets
- Accessibility in Sabah/Sarawak is a challenge due to high cost of infrastructure
- Pollution at water sources caused by human activities & environmental factors
- Presence of multiple agencies in planning & management of water resources resulted in inefficient delivery
- Sewerage: despite large investments in STPs, non-compliance among large number of property owners have resulted in low individual sewerage connectivity

Part III: New Priorities and Emphases (2018-2020):

- NRW target: 31%
- Improve water access in particular for rural areas
- Formulation of a National Sewerage Plan
- 80% sewerage connected services coverage – no change vs previous target
- Formulation of a new Water Services Master Plan

Our initial thoughts on the measures:

New plans in the works. At the centre of the priorities for the water services sector is the formulation of: (1) A new Water Services Master Plan (2) a National Sewerage Plan. At this point no details have been revealed yet but it had been reported that the plan may include a new tariff setting mechanism.

So far, 7 states have already migrated to the licensing regime as outlined under WSIA 2006 (which kickstarted the water services industry restructuring) – water assets transferred to PAAB (national water asset company) and in turn leased back by the State water operators, turning them into asset-light operations. Selangor is in the process of migration.

Restructuring for sewerage sector? Direction of the ailing sewerage sector is likely to be set under the National Sewerage Plan. Among key issues dragging the sector are: (1) Very low fixed tariffs which have not been revised in more than 2 decades – the Government is understood to inject RM200-300m a year into Indah Water (national sewerage company owned by MoF) to fund its operations (2) Poor collection rate as sewerage operators are not allowed to penalise defaulting consumers by disconnecting services (due to public health concerns).

Alternative source of water. Reclaimed water is a potential new source of water for industrial and agriculture use (non-potable) which has yet to be explored in a big way in Malaysia as it requires additional treatment processes of sewerage water which is not feasible at this point due to financial constraint of the sewerage industry.

Joint-billing could be expanded. Joint-billing (to address sewerage charges collection rate) has been implemented in Labuan to much success. We expect Johor (operated by Ranhill's 80%-owned Ranhill SAJ) to be the next state to implement joint-billing of water and sewerage charges.

Tariffs would have to be revised. In the mid-to-longer run, to ensure sustainability of the sewerage industry, we think tariffs will have to be revised higher and switched to a volumetric regime to better reflect capex incurred in maintaining sewerage infrastructure and the growth in consumption.

Ranhill (BUY, TP: RM1.15) is a potential play into this theme in the water and sewerage sector. On top of this, Ranhill is also a potential beneficiary of the NRW reduction drive being one of two key local NRW management players other than Jalur Cahaya (owned by Tan Sri Rozali). Our current TP of RM1.15 has not factored in the potential earning from a water-sewerage integration in Johor which could raise earnings by 30%-40% per annum and lift our valuation to a blue-sky TP of RM1.50.

SECTOR VALUATION COMPARISON

Companies	Rating	Shr Price	PE (x)		P/BV	ROE	Div Yield	Target	Total
		(RM)	FY18	FY19	(x)	(%)	(%)	Price (RM)	Upside (%)
Tenaga	Buy	14.60	11.2	12.6	1.5	10.6	4.4	16.90	20.3
YTL Power	Buy	1.01	11.4	11.3	0.6	5.0	4.5	1.55	55.0
Ranhill	Buy	0.88	12.0	10.2	0.7	13.6	6.8	1.15	20.7
			<i>11.5</i>	<i>11.4</i>	<i>1.0</i>	<i>9.7</i>	<i>5.2</i>		

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MIDF AMANAH INVESTMENT BANK : GUIDE TO RECOMMENDATIONS

STOCK RECOMMENDATIONS

BUY	Total return is expected to be >10% over the next 12 months.
TRADING BUY	Stock price is expected to <i>rise</i> by >10% within 3-months after a Trading Buy rating has been assigned due to positive newsflow.
NEUTRAL	Total return is expected to be between -10% and +10% over the next 12 months.
SELL	Total return is expected to be <-10% over the next 12 months.
TRADING SELL	Stock price is expected to <i>fall</i> by >10% 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.