TENAGA NASIONAL

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Tenaga powers up

Long shunned by investors in favour of the independent power producers (IPPs), Tenaga Nasional Bhd's prospects are now powering up nicely. Investors have historically preferred the IPPs over Tenaga for their earnings certainty and consistent dividends. Much of the IPPs' appeal, ironically, has been at the expense of Tenaga.

We think it is now time for investors to re-look the national utility. Most of the pure IPP plays have been privatised and the first generation players are facing end-of-concession risks. In contrast, Tenaga's investment appeal has strengthened considerably.

Last week's tariff hike is only one of many re-rating catalysts. More importantly, we believe the government is becoming more receptive to tariff hikes to ensure that the national utility has the financial capability to sufficiently invest for the country's growing power needs. Thus, we expect more gradual tariff hikes ahead.

On its own, Tenaga is employing a more aggressive approach in expanding its generating capacity, and is taking on more market share after having lost out to the IPPs over the last two decades. Its cost outlook is looking good, as the company controls its fuel cost mix and benefits from low coal prices.

Tenaga is also shaping up to be one of the market's cheapest large cap stocks with a decent yield to boot. The tariff hike announced last week, combined with higher capacity, will give its earnings a major lift over the next two years. The stock is currently trading at price-earnings multiples of only 13.2 and 10.8 times for financial year ending Aug 31, 2014 (FY2014) and FY2015 respectively, with a net dividend yield of 3% to 3.7%, comparable to bank deposit rates.

Tenaga has been under-rated for some time. This is primarily because its earnings are highly dependent on ad hoc tariff increases, which are subject to government approval. This makes its earnings difficult to forecast. Furthermore, fuel cost — which made up some 56% of its operating costs last year (excluding depreciation and interest) — can vary quite significantly.

For instance, gas shortage from Petroliam Nasional Bhd (Petronas) caused a sharp increase in fuel cost from FY2011 to FY2013 when power producers were forced to run on distillates and oil.

This resulted in a sharp slump in Tenaga's net profit, from RM3.2 billion in FY2010 to just RM970 million in FY2011. Eventually, Tenaga, Petronas and the government each shouldered one-third of the additional bill. With the compensation, Tenaga's net profit recovered to RM4.6 billion in FY2013.

There is no doubt such earnings volatility may happen again, as long as the electricity tariff structure does not contain an automatic fuel cost pass-through mechanism.

Tenaga and the government have long engaged in discussions to implement such a structure. However, the actual timing is elusive. Even if it is implemented, as it once had been for a very brief period a few years back, execution risks remain high given the sensitivity of the subject.

Nevertheless, the stars may be aligning for Tenaga. Recent government decisions have favoured the national utility. Following the fuel cost sharing arrangement mentioned above, the latest tariff hike totalling 4.99 sen per unit included a 0.9 sen per unit upward revision in base tariff for Tenaga.

The rest of the tariff increase, effective January next year, is to cover higher fuel costs as a result of the lower subsidy on gas price — which was raised from RM13.70 per mmbtu to RM15.20 per mmbtu — as well as the higher cost to purchase imported liquefied natural gas (LNG) from the newly completed regasification plant in Melaka.

Demand for electricity is expected to grow by between 3.5% and 4% per annum going forward. With the tariff increase, Tenaga's turnover is estimated to grow 10% per annum, on average, in the next two years.

Cost-wise, things are also looking good for the national utility.

Tenaga and the power producers no longer have to burn expensive distillate-oil (which costs 58 sen per unit generated) now that it can supplement the shortage with imported LNG. The distillate-oil alternative fuel had cost them an additional RM1.68 billion in FY2013, which was eventually shared between Tenaga, Petronas and the government.

That will result in a RM560 million cost saving for Tenaga in the future. The higher cost of imported LNG is covered by the latest tariff increase.

Thermal coal prices have also fallen well off their peak. They averaged as high as US$142 per tonne in January 2011, and are currently selling at around US$85 per tonne. Prevailing market forecasts for the next few years are modest, with prices ranging from US$80 to US$100 per tonne. This will help keep a lid on Tenaga's future fuel bill.

Coal is the cheaper fuel compared with

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gas and oil. Its per unit cost is roughly 11 sen compared with about 13 sen for subsidised gas and up to 35 sen for imported LNG.

Tenaga is building proportionately more coal plants. The coal-fired Manjung 4 and 5 with a total capacity of 2,000MW are slated to be commissioned in FY2015 and FY2018 respectively, while only one 1,000MW gas-fired plant is planned for FY2016. The national utility is also commissioning two hydro plants, which have zero fuel cost. These have a total capacity of 637MW and will be commissioned in FY2016.

In short, the overall fuel cost per unit generation is expected to be relatively steady while the company builds up its own capacity.

Gas prices may rise again next year should the government decide to continue lowering subsidies. But if history is any guide, it should be a neutral event for Tenaga. The national utility has managed to fully pass through the higher gas prices, so far. Prior to this latest round of tariff hike, the last increase of some 7.1% was in June 2011 when the gas price was raised from RM10.70 per mmbtu to RM13.70 per mmbtu.

Additionally, three of the first generation power purchase agreements with a total capacity of 2,092MW — including 1,212MW from YTL Power International Bhd — will expire between September 2015 and January 2016. Their capacities will be replaced by more competitively priced power from the new generation of IPPs, specifically the 1,000MW Tanjung Bin expansion in FY2016 and 2,000MW track B project by FY2019.

We forecast Tenaga's net profit will rise to nearly RM4.7 billion in FY2014 and RM5.7 billion in FY2015 — up from RM4.12 billion in FY2013, excluding unrealised forex gains. At the current price of RM10.94, its shares are trading at 13.2 and 10.8 times our estimated earnings for the two years.

In line with the higher earnings and operating cash flows, we expect Tenaga to raise its dividends to about 33 sen and 40 sen per share in FY2014 and FY2015, respectively. That will earn shareholders net dividend yields of 3% to 3.7%. Based on our forecasts, its balance sheet will remain strong with gearing estimated at 39% and 36% for the two years. E

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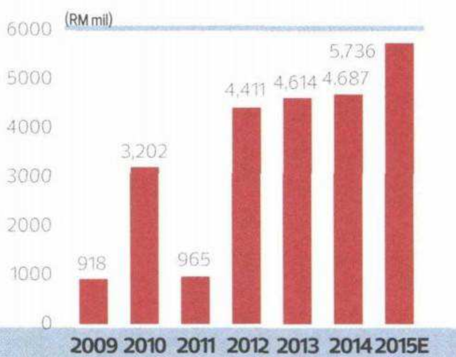

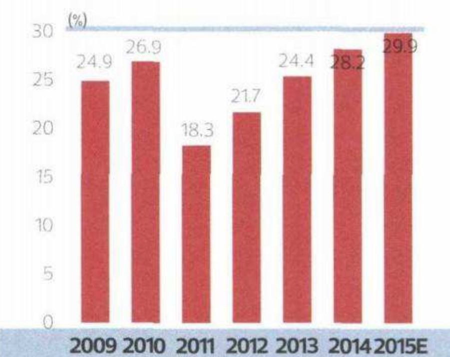

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