

July 27, 2017 04:09 PM GMT

Tenaga Nasional

Growing Clarity on Challenges Ahead

Stock Rating
Underweight

Industry View
In-Line

Price Target
RM12.59

Increased clarity on profitability of regulated business and tax rates points to downside risks to consensus earnings for next two years. Inorganic growth remains part of management commentary as key to becoming a top ten global utility -- could add further challenges to returns.

Comparison of the results with our/consensus estimates

- Tenaga reported EBITDA and earnings below our and consensus estimates, due to lower demand, higher tax rate and finance costs. Core profit for quarter ending May-17 declined 11% YoY, while reported earnings were lower by 23% due to one-time deferred tax impact.
- Electricity demand growth remained weak at 0.7% YoY in 9M17, as both commercial and residential demand normalised post the heat wave. Interestingly, industrial demand rose for 2nd consecutive quarter, but is still 0.5-1% below its earlier growth rates.
- Regulatory capital spending is averaging ~20% below the approved budget, and this could add further risks to regulated earnings. Tax rate is normalising and rose to ~13% (after remaining <10% for past two years). Management expects tax rate to revert to 20+% by end-2018.

Biggest surprises in the result announcement

- TNB disclosed its regulated business earnings for the first time, as part of the unbundling exercise. While the earnings were 5-6% below our estimate, the key takeaways from the disclosure are: 1) Regulated earnings account for 60% of profits, while regulated asset base accounts for 40% of the total assets; 2) Generation business has an ROA of ~2-2.5%, one of the lowest vs. regional peers; 3) a 50bps reduction in regulated WACC (as regulator assesses TNB's regulated returns) would have potential to drive ~5% decline in consensus earnings next year.

Recommended investment/stock action

- Maintain UW on Tenaga and see risks from the government's lowering its regulated returns (which it's currently over-earning), increasing risk of commodity cost inflation and challenges to capital allocation. (Details [here](#)). Prefer MERALCO and EGCO.

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Tenaga Nasional (TENA.KL, TNB MK)

ASEAN Utilities / Malaysia

Stock Rating	Underweight
Industry View	In-Line
Price target	RM12.59
Up/downside to price target (%)	(12)
Shr price, close (Jul 27, 2017)	RM14.24
52-Week Range	RM14.90-13.00
Sh out, dil, curr (mn)	5,644
Mkt cap, curr (mn)	RM80,365
EV, curr (mn)	RM100,738
Avg daily trading value (mn)	RM142.43

Fiscal Year Ending	08/16	08/17e	08/18e	08/19e
ModelWare EPS (RM)	1.36	1.23	1.16	1.14
Prior ModelWare EPS (RM)	-	-	-	-
Consensus EPS (RM)§	1.30	1.33	1.31	1.34
Revenue, net (RM mn)	44,491	42,967	43,516	44,801
EBITDA (RM mn)	14,149	14,665	14,859	15,100
ModelWare net inc (RM mn)	7,700	6,961	6,529	6,453
P/E	10.8	11.5	12.3	12.5
P/BV	1.6	1.4	1.4	1.3
FCF yld ratio (%)	(0.2)	(0.1)	5.2	6.0
ROE (%)	16.3	13.3	11.7	10.9
EV/EBITDA	7.3	6.9	6.7	6.5
Div yld (%)	2.1	4.2	4.5	4.5
Leverage (EOP) (%)	78.9	74.1	68.3	62.2

Unless otherwise noted, all metrics are based on Morgan Stanley ModelWare framework

§ = Consensus data is provided by Thomson Reuters Estimates

e = Morgan Stanley Research estimates

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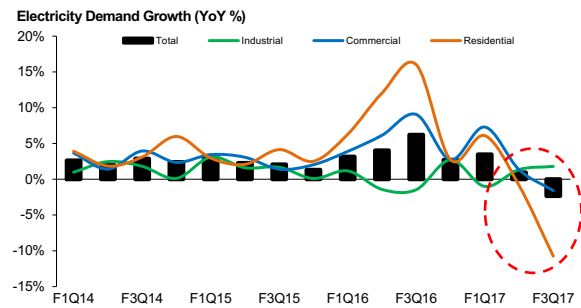
F3Q17 in Charts

Exhibit 1: TNB: 3Q17 profit missed, due to higher fuel and financing costs

Income Statement (RM mn)	F3Q17	F3Q16	% YoY	F2Q17	% QoQ
Net Revenue	12,549	12,129	3%	11,162	12%
Operating Expenses	8,455	8,102	4%	7,833	8%
Total IPP Purchases/Costs	3,637	3,085	18%	3,445	6%
Fuel Costs	2,525	2,312	9%	2,278	11%
Repair & Maintenance	546	509	7%	462	18%
Staff Costs	948	969	-2%	806	18%
TNB General Expenses	378	965	-61%	590	-36%
Subs Gen Exp, COS + Provisions	423	262	61%	252	68%
EBITDA	4,094	4,027	2%	3,329	23%
Depreciation & Amortisation	1,582	1,468	8%	1,508	5%
EBIT	2,512	2,559	-2%	1,821	38%
FX transaction gain/(loss)	21	30	-32%	7	185%
FX translation gain/(loss)	6	(40)	NM	29	-79%
Other Operating Income	202	188	7%	158	28%
Finance income	5	29	-84%	7	-37%
Finance costs	(489)	(260)	88%	(391)	25%
Share of results of associates	(11)	19	NM	62	NM
Pre-tax profit	2,251	2,532	-11%	1,700	32%
Tax	486	225	116%	259	87%
Profit after tax	1,765	2,307	-24%	1,440	23%
Minority interest	(14)	2	NM	(42)	NM
Profit attributable to shareholders	1,778	2,309	-23%	1,482	20%
Core Profit	2,057	2,318	-11%	1,451	42%

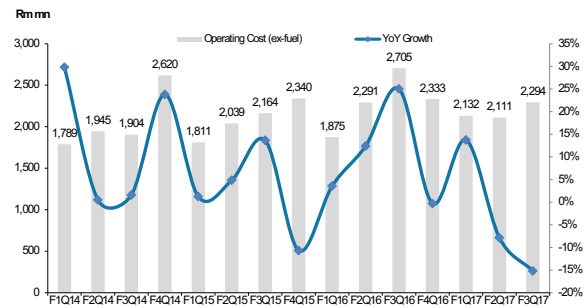
Source: Company data, Morgan Stanley Research

Exhibit 2: F3Q17 overall electricity demand fell 2.4% as demand for Residential fell due to El Nino in previous year and as commercial demand declined



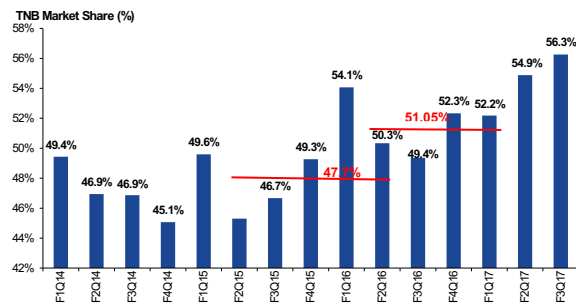
Source: Company data, Morgan Stanley Research

Exhibit 3: TNB: Operating cost (ex-fuel) dropped 15% YoY but rose 9% QoQ



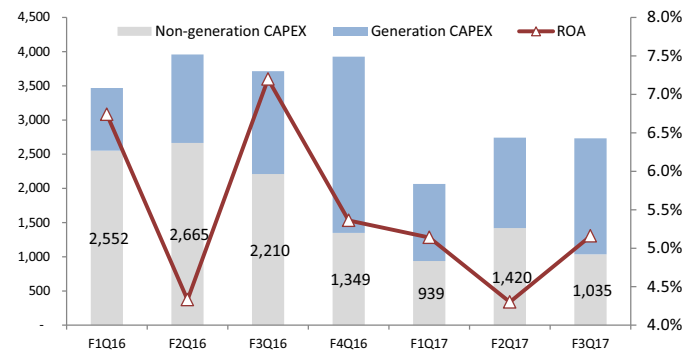
Source: Company data, Morgan Stanley Research

Exhibit 4: TNB: Generation market share averaged 54.5% for past three quarters, as gas-based TNB generation increased



Source: Company data, Morgan Stanley Research

Exhibit 5: TNB: T&D capex down by 53% YoY but ROA still down by 2ppt YoY



Source: Company data, Morgan Stanley Research

Valuation Methodology and Risks

TENA.KL

Our price target of RM12.59 is our base case scenario value. We use a DCF approach, based on a financial model that factors in assumptions for Tenaga's core power supply business and other electricity-related investments. We calculate DCF value by using a 10-year unleveraged FCF model, and we consider terminal value for the business after 2025. In deriving our terminal value, we capitalize our terminal-year FCF projection by our WACC and incorporate 1.0% perpetual growth. We assume a 9.3% WACC and assume full fuel cost pass-through in power tariffs, implying automatic pass-through of any gas-cost fluctuations.

Upside risks to achieving price target: Increase in regulatory WACC for its distribution/transmission business; higher demand growth amid stronger GDP.

MER.PS

Our price target for Meralco is 352 PHP/share. We value Meralco using DCF, considering its 11-year remaining concession life (with a franchise up to 2028) for the distribution business and 30-year concession life for the coal-fired generation capacity under construction. Also, with the delay in regulatory approvals until 2H18, we believe using specific-year earnings could lead to overestimating core value. We calculate the DCF value by using a 10-year unlevered FCF model, with a terminal value for the business after 2025. In deriving our terminal value, we capitalize our terminal-year FCF projection by our WACC and incorporate 3.0% perpetual growth. We assume a 7.7% WACC.

Risks to Achieving Price Target

- Potential sale by parent company to fund growth capex. However, the companies have not made any suggestions to this effect.
- Higher-than-provisioned litigation costs

EGCO.BK

Our price target of Bt245 is our base case scenario value, derived from a DCF methodology, which we use to capture the long-term gestation life of its generation capacity. We use a risk-free rate of 3.3%, i.e., five-year average of Thailand's 10-year bond yield. We use a long-term debt/equity ratio of 0.8x to highlight EGCO's ambitious growth strategy in a world of low interest rates. We apply a beta of 0.63x, leading us to a cost of equity of 8.3% and cost of debt of 4.8%. We arrive at a WACC of 6.7%. We assume a 2% long-term growth rate (in line with Thailand's 10-year average electricity growth).

Key Downside Risks to Achieving Price Target

- Higher interest rates and new acquisitions could lead to lower DPS.
- Higher Thailand 10-year bond yields
- Delays in execution of new capacity ramp-ups

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(as of June 30, 2017)

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STOCK RATING CATEGORY	COVERAGE UNIVERSE		INVESTMENT BANKING CLIENTS (IBC)			OTHER MATERIAL INVESTMENT SERVICES CLIENTS (MISC)	
	COUNT	% OF TOTAL	COUNT	% OF TOTAL IBC	% OF RATING CATEGORY	COUNT	% OF TOTAL OTHER MISC
Overweight/Buy	1147	36%	295	40%	26%	560	37%
Equal-weight/Hold	1402	44%	342	46%	24%	688	45%
Not-Rated/Hold	62	2%	8	1%	13%	10	1%
Underweight/Sell	608	19%	92	12%	15%	255	17%
TOTAL	3,219		737			1513	

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Stock Price, Price Target and Rating History (See Rating Definitions)

Electricity Generating Public Company (EGCO.BK) - As of 7/27/17 in THB
Industry : ASEAN Utilities



Stock Rating History: 7/1/14 : NA/I; 7/17/14 : O/I

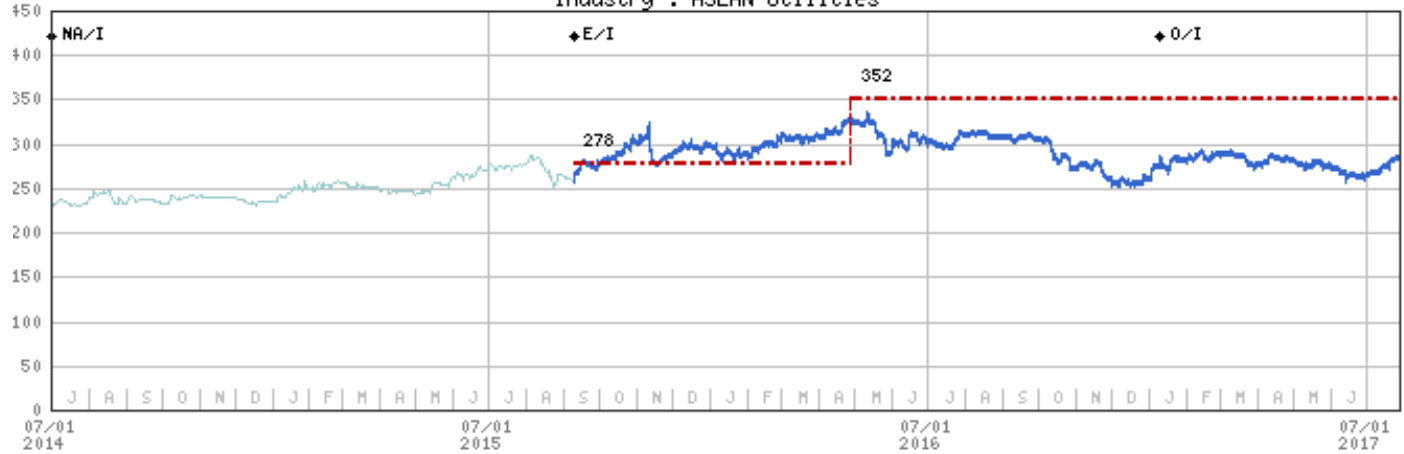
Price Target History: 7/17/14 : 165; 7/12/16 : 245

Source: Morgan Stanley Research Date Format : MM/DD/YY Price Target --- No Price Target Assigned (NA)
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Manila Electric Company (MER.PS) - As of 7/27/17 in PHP
Industry : ASEAN Utilities



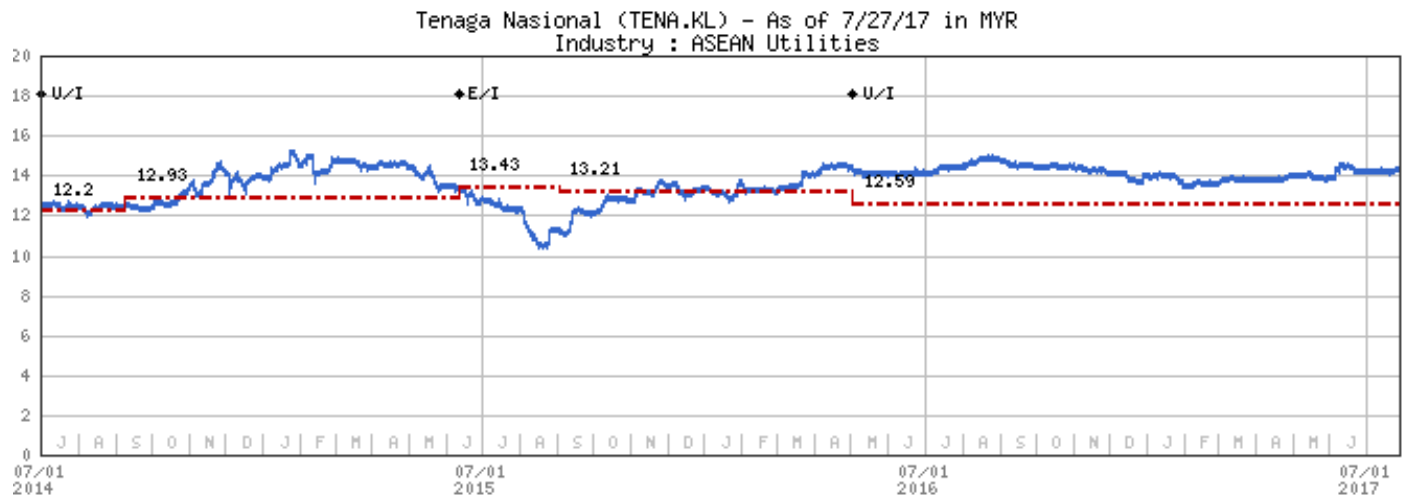
Stock Rating History: 7/1/14 : NA/I; 9/9/15 : E/I; 1/10/17 : O/I

Price Target History: 9/9/15 : 278; 4/27/16 : 352

Source: Morgan Stanley Research Date Format : MM/DD/YY Price Target --- No Price Target Assigned (NA)
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INDUSTRY COVERAGE: ASEAN UTILITIES

COMPANY (TICKER)	RATING (AS OF)	PRICE* (07/27/2017)
Mayank Maheshwari		
Aboitiz Power Corporation (AP.PS)	E (01/10/2017)	PP40.00
Electricity Generating Public Company (EGCO.BK)	O (07/17/2014)	Bt222.00
Energy Development Corporation (EDC.PS)	O (01/10/2017)	PP5.90
Glow Energy (GLOW.BK)	U (11/25/2015)	Bt79.50
Malakoff Corporation Berhad (MALAKL)	U (06/23/2015)	RM1.04
Manila Electric Company (MER.PS)	O (01/10/2017)	PP282.80
Perusahaan Gas Negara (PGAS.JK)	O (09/09/2014)	Rp2,240
Ratchaburi Electricity (RATCH.BK)	U (07/17/2014)	Bt54.00
Tenaga Nasional (TENAKL)	U (05/02/2016)	RM14.24

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* Historical prices are not split adjusted.

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