TNB falls further on Morgan Stanley downgrade
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Tenaga Nasional Bhd (TNB) shares fell for a second consecutive day today after Morgan Stanley Research downgraded the company to underweight, a re-rating that factored in reforms and cost controls.

At the 5pm bell today, TNB was down 44 sen at RM11.30 per share, continuing a sharp decline since the month began. TNB's shares closed at RM11.96 on March 31.

In a report dated April 2, Morgan Stanley said it was downgrading Tenaga from overweight to underweight following the latter's 48% outperformance versus that of the Kuala Lumpur Composite Index (KLCI), as it believes current valuations are pricing in a return on equity (ROE) of 12%.

This was despite uncertainties on the fuel cost pass-through, cost inflation reaching above Tenaga's stated targets, slower electricity demand growth in the rising tariff environment and unattractive valuations compared to those of its regional peers.

"Peers have higher growth and ROE upside at valuations that are 20% cheaper on a P/B/ROE and EV/RNOA basis. In the past one year, investors' focus has been on a paradigm shift in TNB's ROIC (return on invested capital) profile & earnings certainty," the research house said.

"We lower our earnings for F2014 – 16 by 3% to 8% on the back of higher staff and maintenance costs, and factor in higher interest cost due to depreciation of the MYR/USD. However, we do not factor in any downside risks on fuel costs or delay in government reforms."

"Our F2015 price target is RM12.2/share, i.e. a marginal 2% from current levels despite assuming reform implementation with TNB bearing no fuel cost related risks. We see 10% to 20% downside risk to consensus F2014-16 EPS driven by lower demand growth and higher non-fuel operating costs. Our preference within Asean utilities moves to PGAS in Indonesia."

Commenting on the reasons for the underweight call, the research house said there are four uncertainties which "could de-rail ROE to below 12%".

Firstly, the research house pointed out that an electricity tariff hike is not automatic, requiring cabinet approval. Rising fuel cost (namely gas) coupled with the depreciating ringgit, leads to rising uncertainty on TNB's quarterly EPS (earnings per share), the research house said.

"There are mechanisms to cushion tariff increases in 2014, but most are unsustainable and could lead to a de-rating. We estimate ~10% downside risk to TNB's 2014 EPS in the event of no tariff hike."

Another area of concern is the fuel mix. "With design-level challenges in coal power plants, TNB's usage of high cost LNG fuel could sustain above regulatory targets, increasing cost uncertainty. We expect downside risk of 4% to 2014/15 EPS if TNB bears 50% of the additional fuel costs", Morgan Stanley said.

The research house also commented on TNB's execution of cost controls, saying that this will be the key driver for upside ROE surprise. "However, with a slow execution track record in past years, we see downside risk from staff and maintenance cost. We reduce F14/15 EPS by 7-8% to factor higher non-fuel costs and estimate a 13% Cagr cost growth (TNB's target at 5%).

Source: http://www.kinibiz.com/story/corporate/79418/morgan-stanley-downgrades-tnb-to-underweight.html