

TNB STOCK GETS A CHARGE

It's almost a foregone conclusion that TNB will get the tariff hike it is asking for. Analysts are already bullish on the stock.

By James S

THE odds are rising that Tenaga Nasional Bhd (TNB) will get its long-asked-for tariff hike this year, stepping up momentum for 'buy' calls by analysts on the stock.

Energy, Water and Communications Minister Datuk Seri Dr Lim Keng Yaik said in late January his ministry would submit a paper on TNB's proposed tariff hike to the Cabinet within two months. He was quoted as saying he had briefed the Prime Minister and his deputy on TNB's proposal and that his ministry had been given the go-ahead to present the paper.

In what is likely to be the clearest indication thus far, Lim said his ministry was sympathetic to TNB's request but 'not to its full request'. The minister said the paper would be prepared as soon as possible, but would not take longer than two months.

Probably to soothe consumers' fears, he gave an assurance that the tariff review would not affect the lower-income group.

How much of a hike?

No one really knows what the revision will be. AmResearch Sdn Bhd, in a recent review note, says the market is expecting a 1% to 10% 'premium hike' according to data collected by TNB. Note that for a tariff hike to benefit TNB's earnings, the

Government must approve a quantum that is sufficient to cover a likely gas price increase by Petronas Bhd, as this is one of the major components of TNB's overall fuel costs – hence the term 'premium hike' used by analysts.

Most analysts expect Petronas to raise its gas price to TNB by between 30%-50%, which may translate to a 6%-11% tariff hike in electricity prices.

AmResearch says it is maintaining a 1% net premium hike assumption (ie, a 7%

gross upward revision in power tariff on the back of a 25% upward revision in the price of gas for the power industry). Based on its sensitivity analysis, it estimates that a 1% premium hike will bump up TNB's net profit by approximately RM130 million over a 12-month period.

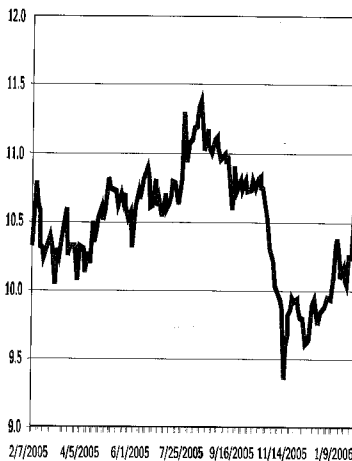
Based on its FY05 net earnings of RM1,280 million, this means a tariff hike could potentially see a 10% boost to TNB's bottom line. However, with most analysts already factoring in a tariff hike of between 6%-11% in their earnings forecasts for the power company, one can assume that TNB's consensus earnings estimate of RM1,939 million for FY06 already reflects the tariff hike scenario.

In other words, an actual power tariff hike could be a non-event for the stock.

In all fairness, the investment community already believes that a tariff hike for TNB is a foregone conclusion given the Government's commitment to reducing its overall fuel subsidies to the economy. This means allowing Petronas to raise the current gas price it charges TNB and the power industry, which has been fixed at RM6.40/mmBtu since May 1997.

The Government had refused to grant Petronas approval to raise this price since May 1997, apparently aiming to stabilise electricity charges, which had since also

CHART 1: TNB'S ONE-YEAR DAILY SHARE PRICE MOVEMENT



Source: Bloomberg

been fixed at the May 1997 level.

But with escalating prices, it appears the Government has little choice but to pass some of the burden to consumers. Further, TNB's other fuel components like coal and crude oil have been rising over the last few years, eroding the power company's profit margin and dampening its earnings prospects.

Tariff hike justified?

Morgan Stanley Research, in a previous investment report on the company, says a net tariff hike for TNB is justified on several grounds. Firstly, the cost of gas price subsidies by the Government to the power sector is getting unbearable, with the price fixed at RM6.40/mmBtu versus a current market price of around RM25.0/mmBtu.

Secondly, TNB's tariff remains one of the lowest in Asia, due mainly to its subsidised gas cost from Petronas. The research house estimates that even if Petronas raised its gas charge entirely to the price of RM25.0/mmBtu, TNB's electricity tariff of RM30.23 sen/kWh would still be in line with those of

TABLE 1: EARNINGS (-ve) ; REC (unch)

YE 31 Aug	2004	2005	2006F	2007F	2008F
Pretax profit (RM m)	1,482.7	1,818.9	2,799.1	2,653.8	2,899.6
Net profit (RM m)	813.7	1,280.0	2,018.3	1,754.5	1,939.4
Pretax profit (ex-EI) (RM m)	2,054.5	1,677.1	2,317.6	2,653.8	2,899.6
Net profit (ex-EI) (RM m)	1,385.5	1,138.2	1,536.8	1,754.5	1,939.4
Revision (%)			(14.1)	(5.3)	(7.1)
Revision (Ex-EI) (%)			(7.5)	(5.3)	(7.1)
Consensus (RM m)			1,939.8	2,237.2	2,495.9
Share capital (m shares)	3,119.6	3,190.1	3,233.2	3,233.2	3,233.2
EPS (sen)	26.1	40.1	62.4	54.3	60.0
EPS Growth (%)	(27.2)	53.8	55.6	(13.1)	10.5
EPS (ex-EI) (sen)	44.4	35.7	47.5	54.3	60.0
EPS Growth (ex-EI) (%)	20.2	(19.7)	33.2	14.2	10.5
CFPS (sen)	127.1	121.2	133.4	146.3	153.6
Gross DPS (sen)	17.00	15.00	16.00	17.00	18.00
NTA/share (RM)	4.64	4.95	5.41	5.83	6.31
PER (X)	40.3	26.2	16.8	19.3	17.5
PER (ex-EI) (X)	23.6	29.4	22.1	19.3	17.5
P/CFPS (X)	8.3	8.7	7.9	7.2	6.8
Gross yield (%)	1.6	1.4	1.5	1.6	1.7
P/NTA (X)	2.3	2.1	1.9	1.8	1.7
ROE (%)	5.5	8.0	11.4	9.2	9.4
EV/EBITDA (X)	11.1	10.9	9.6	9.1	8.7
EBITDA margin (%)	33.1	30.6	32.0	30.1	29.1
Effective tax (%)	45.5	27.3	26.4	32.3	31.6

Source: AmResearch

other Asian countries (see Chart 2).

Thirdly, according to Morgan Stanley, TNB's return on capital invested (ROIC) at 5.1% is low (deteriorating from 10.5% in FY94) when benchmarked against other utilities in the region and worldwide. Such sub-optimal return levels could jeopardise TNB's ability to invest in power infrastructure.

The research house, in expecting an 11.4% increase in TNB's electricity tariff in 2006, says TNB's ROIC would then rise to a more reasonable 7.5%, although it would still be below that of other dominant power players in Asia.

Balancing act

The whole affair is a tricky balancing act for the Government between its concern for the rise in the people's cost of living and the need to give TNB – of which it is also a major shareholder – a level playing field.

AmResearch says a way of resolution for the Government could be to restrict the hike to the commercial and industrial sector (which accounts for 80% of TNB's sales), while maintaining the present tariff for the remaining users, typically

households.

Still, this is not a perfect solution as given time, businesses are likely to pass the cost (more often in a disproportionate manner) to consumers in the form of higher cost of goods and services.

According to CIMB Research, neighbouring countries' plans to raise their power rates in February-March 2006 would allay the Malaysian Government's fears over the potential impact of higher tariffs on foreign direct investments (FDI) and would strengthen TNB's case for a tariff review.

It says Malaysia's current tariff rate of 23.5 sen per kWh is among the lowest in the region and is below Indonesia's 25.3 sen and Thailand's 27.5 sen.

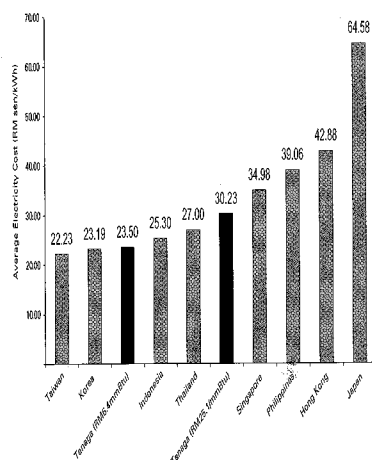
Thailand is expected to raise its retail power tariff by about 12% to 3.087-3.097 baht/kWh in February 2006, mainly because of higher demand for electricity and the rising cost of generation. In Indonesia, the National Planning Minister has warned that electricity tariffs for large industries and middle-income to upper-income households may surge by 86%-100% by March 2006 to cover the rise in the cost of generation fuelled by higher oil and coal prices.

Weak first-quarter results 'timely'?

In a case that is likely to strengthen TNB's tariff hike proposal, the power company reported a lower-than-expected set of 1Q results for FY06 (August year-end). It posted RM595.6 million in net profit, which is substantially higher than the RM8.5 million recorded in 1QFY05 and 48% higher quarter-on-quarter.

The results included RM362.5 million in foreign exchange gain (against RM442.1 million forex loss in 1QFY05 and RM270.4 million gain in 4QFY05), offset against a foreign exchange transaction loss of RM140.9 million arising from the

CHART 2: ASIAN UTILITIES ELECTRICITY RATES IN 2004



Source: Morgan Stanley Research

unwinding of cross-currency swap.

Stripping out the net foreign translation gain and losses from the swap-related transactions, the group's 1QFY06 core net profit stood at RM374 million, 17% lower year-on-year (y-o-y). Analysts attribute this to higher-than-expected other expenses.

Avenue Securities in its report says TNB's 1QFY06 revenue grew 8.1% y-o-y on the back of electricity demand growth of 8% y-o-y, led by the commercial (+9.6%) and domestic (+12.1%) segments.

However, the overall 1Q operating cost increased by a higher 12.1% y-o-y, due mainly to higher fuel cost (+28.9% y-o-y) as the average coal price increased from US\$49.8/tonne for 1QFY05 to US\$52.5/tonne for 1QFY06.

In addition, other operating expenses grew more than three-fold to RM450.2 million for the quarter. It says one of these expenses was a debtor provision of RM142 million for unpaid bills of over 12 months, while the rest were RM37 million in gas curtailment cost

and increases in daily operating costs.

Avenue adds that the numbers could be somewhat misleading as TNB could be reporting lower earnings for tariff hike negotiation.

AmResearch, in an earlier results preview note, concurs somewhat. It says as the national utility is lobbying for a tariff hike, some may argue it is not in its interest to announce a set of good results for fear of a public backlash.

If true, says AmResearch, TNB would possibly choose to recognise most of its periodic cost upfront and deferred earnings enhancement entries (ie, treatment of grants and subsidies) as much as possible to later periods of the FY.

Rising optimism – hike in sight

It's not surprising market analysts are getting buoyant over TNB as the company may finally be getting its first tariff hike in eight years in the next few months. CIMB says TNB remains its top government-linked company (GLC) pick

for its restructuring efforts, tariff hike prospects and strong earnings outlook.

Other research houses like Avenue, Affin Research and TA Research also recommend the stock. However, some like AmResearch say TNB's valuation at 21.1x and 18.7x price-earnings (PE) multiples for 2006 and 2007 respectively are already quite rich at 62% premium to the overall market's current valuations of 13x for 2006.

Despite the company's lower-than-expected set of results recently, it looks like TNB is likely to get the benefit of the doubt as expectations of a tariff hike are expected to rally advocates to its side in the near term.

The flip side is that consumers are not likely to cheer the company's good news, especially if the tariff hike is not accompanied by improved efficiency and efforts by the power company to address reported shortcomings such as late connectivity, power outages and lacklustre customer service. **imb**