

Tenaga Nasional

Recommendation: **STRONG BUY**

Stock Code: 5347

Bloomberg: TNB MK

Price: MYR9.30

12-Month Target Price: MYR13.00

Date: February 19, 2008

Board: Main

Sector: Trading/Services

GICS: Utilities/Electric Utilities

Market Value - Total: MYR40,236.5 mln

Summary: Tenaga Nasional (Tenaga) is the electricity utility company in Malaysia and is mainly involved in the generation, transmission and distribution of electricity. Tenaga manages the electricity grids in both Peninsular Malaysia and Sabah.

Analyst: Alexander Chia, ACA



Highlights

- Electricity demand in 1QFY08 (Aug.) surprised on the upside, surging 7.7% YoY. We are maintaining our 6% electricity demand growth assumption for now, given that 2Q demand is seasonally lower.
- While Tenaga has secured 81% of its coal requirements for FY08 at an average price of US\$60.30/MT (vs. US\$45.30/MT for FY07) despite spot coal prices that are currently above US\$90/MT. Spiraling coal prices remain a concern for earnings in FY09 and beyond given that Tenaga is already utilizing all of its 1,350 mmbtu allocation of subsidized gas. Incremental electricity demand will have to be met from increasingly expensive non-gas sources.
- Tenaga has been a key GLC restructuring success story having in recent years improved operating efficiencies, pared down debt, disposed of non-core assets as well as successfully securing a 12% tariff revision in Jun. 2006

Investment Risks

- Risks to our recommendation and target price include Tenaga being made to absorb higher gas prices, the continued upward spiraling of non-gas fuel costs and weaker-than-expected electricity demand growth. The continue deferment of a fuel cost pass-through formula in a rising fuel cost environment is also a risk.

Recommendation

- We reiterate both our 12-month target price of MYR13.00 and Strong Buy recommendation on the back of undemanding valuations.
- Our target price is DCF-based (WACC of 7.9% - 8.2% and terminal growth of 3%) and includes our forecast FY08 net dividend of MYR0.26. We continue to impute a 20% discount to our DCF estimate to reflect regulatory risks.
- The weak relative performance of Tenaga's share price stems from market concerns over surrounds management's inability to adjust its product pricing to match costs, given that electricity tariffs are government-controlled while a large proportion of operating costs are market-based. The balance that needs to be struck between social concerns and achieving a sustainable market return on Tenaga's assets and investments has been tilted toward the former in recent years. However, the current situation is clearly unsustainable given the amount of subsidies involved.
- The introduction of a cost pass-through tariff formula would be a major milestone for Tenaga and will likely be a catalyst for the re-rating of its share price, in our opinion. However we do not expect such a mechanism to be introduced until the dust from the forthcoming General Elections has settled.

Key Stock Statistics

	2007	2008E
FY Aug.		
Reported EPS (sen)	95.3	91.9
PER (x)	9.8	10.1
Dividend/Share (sen)	36.3	37.7
NTA/Share (MYR)	5.63	6.00
Book Value/Share (MYR)	5.63	6.00
No. of Outstanding Shares (mln)	4,326.5	
52-week Share Price Range (MYR)	8.80 - 12.40	
Major Shareholders:	%	
Khazanah Nasional Bhd	37.0	
Bank Negara Malaysia	11.1	
Employee Provident Fund Board	10.9	

Per Share Data

	2005	2006	2007	2008E
FY Aug.				
Book Value (MYR)	4.00	4.80	5.63	6.00
Cash Flow (sen)	101.2	134.5	170.9	167.8
Reported Earnings (sen)	32.1	52.5	95.3	91.9
Dividend (sen)	13.0	14.8	36.3	37.7
Payout Ratio (%)	32.9	24.4	32.3	32.0
PER (x)	29.0	17.7	9.8	10.1
P/Cash Flow (x)	9.2	6.9	5.4	5.5
P/Book Value (x)	2.3	1.9	1.7	1.6
Dividend Yield (%)	1.4	1.6	3.9	4.1
ROE (%)	7.4	10.1	16.5	14.8
Net Gearing (%)	168.7	119.3	77.8	72.8

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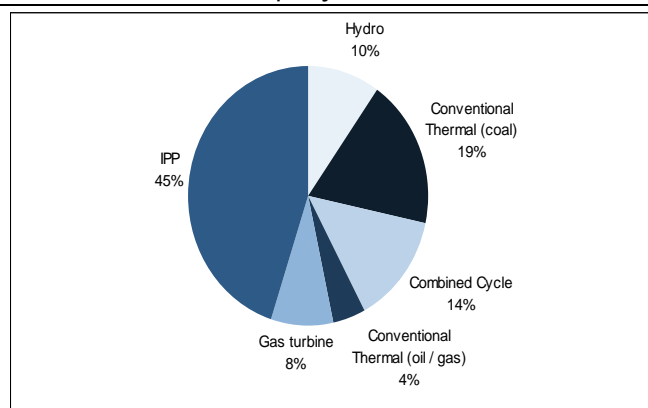
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Business

Tenaga is Malaysia's national electricity utility company. Its revenues are mainly derived from the sale of electricity to nearly 7 mln customers. These include customers in the domestic, commercial, industrial, mining and public sectors. Other contributors to group revenues include Liberty Power, a 235MW gas-fired IPP located in Sindh Province, Pakistan, along with other subsidiaries involved in the manufacturing of transformers, high voltage switchgears and cables, professional consultancy services, architectural, civil and electrical engineering works and services, repair and maintenance services, property development, project management services and higher education through Universiti Tenaga Nasional.

Tenaga's installed electricity generating capacity is 11,515MW or 61.5% of the country's total installed capacity at end-FY07 with the remainder owned by the various independent power producers (IPPs). Of this, approximately 82% comes from thermal power plants (coal, oil or natural gas-fired) and the balance from hydroelectric plants. Of this total generating capacity, approximately 41% comes from gas-fired plants, 8% from conventional multi-fuel plants and 34% from coal-fired plants. Malaysia currently enjoys a comfortable reserve margin estimated at 44% as a result of over-planting, which is inefficient from Tenaga's perspective.

FY07 Installed Generation Capacity

Source: Company data, S&P Equity Research

The IPPs focus purely on generation, supplying electricity exclusively to Tenaga, who owns and operates the National Grid.

Electricity tariffs require approval from the government and were revised in Jun. 2006 by about 12%, taking average tariffs to 26.3 sen/kWh. The previous average tariff of 23.5 sen/kWh had been effective since May 1997.

Fuel costs (including payments to IPPs) form the largest component of Tenaga's operating costs. The price of gas supplied to Tenaga and the IPPs has been fixed at MYR6.40/mmbtu to partially subsidize the cost of electricity generation, given that market prices are considerably higher. However, other non-gas fuel components have to be procured by Tenaga at competitive prices, in particular distillates and coal. While Tenaga has managed to procure 81% of its coal requirements for FY08 at an average price of US\$60.30/MT, up from the average of US\$40.30/MT in FY07, fuel costs will remain under pressure going forward given that spot prices for coal remains above US\$90/MT. The entire subsidized gas allocation of 1,350 mmbtu is already being utilized by Tenaga and the IPPs. Tenaga will look to manage fuel costs through tactical purchasing, seeking new sources of coal supply (offering long-term supply contracts at favourable prices) and planning for new hydroelectric plants for the medium term.

Recent government-sponsored efforts to renegotiate the terms of the early (first generation) PPAs with the IPPs have not resulted in a compromise.

The national oil company Petronas has also sought for a review of the subsidized gas price. Management has reiterated their understanding with the government that gas prices will not be raised without a corresponding adjustment in electricity tariffs.

Earnings Outlook

Demand-pull factors from the rising demand for electricity will continue to drive Tenaga's revenue. Its 1QFY08 results surprised on the upside with electricity demand growth surging 7.7% YoY. However given the seasonally slower 2Q and the as yet undetermined impact of the U.S. slowdown on Malaysia's economy, we are maintaining our electricity demand forecast at 6% for FY08.

In conjunction with the Khazanah-led GLC revamp, Tenaga's management has focused on improving efficiency and better managing costs. Efforts to reap "low hanging fruit" include: (i) better managing costs and improving operational efficiency, (ii) more aggressively dealing with delinquent debts, (iii) minimizing transmission and distribution losses (every 1% saving is equivalent to MYR68 mln), (iv) more efficient debt management to minimize average interest costs, (v) tactical sourcing of coal supply, (vi) government support for Sabah Electricity (SESB), (vii) development of strategically located Klang Valley land bank in JV with partners, (viii) increased electricity sales to EGAT, (ix) revamp of its procurement policies and practices in conjunction with a Khazanah-led initiative, (x) rebalancing of its capital structure.

The Federal subsidy package for SESB announced in Mar. consists of a MYR720 mln debt write off over 10 years, diesel and medium fuel oil subsidies and a reduction in interest rates to 4% from 6%. MYR436 mln was recognized in FY07.

Tenaga's balance sheet has improved considerably in the past two years following operational improvements, sale of non-core assets together with the tariff revision. Net gearing has fallen to a manageable 69.3% at end-1QFY08 from 169% at end-FY05. Management continues to guide for annual capex of between MYR4.0 bln-MYR4.5 bln.

Historically Tenaga's pre-tax profit track record has been volatile as a result of its accounting policy for the treatment for forex gains and losses. Earnings in 1QFY08 were boosted by forex gains of MYR242 mln.

Our FY08 and FY09 net profit forecasts stand at MYR3,918 mln and MYR3,865 mln, respectively.

Key risks to earnings include rising non-gas fuel costs, Tenaga being made to absorb a reduction in the gas subsidy without a corresponding tariff adjustment, weaker than expected electricity demand and the continued postponement of a cost pass through mechanism.

Valuation

Our target price is DCF-based (WACC of 7.9% - 8.2% and terminal growth of 3%) and includes our forecast FY08 net dividend of MYR0.26. We continue to impute a 20% discount to our DCF estimate on account of the heightened risk environment, given the absence of a fuel cost pass through mechanism and the government's historical propensity prioritizing social concerns over the need to achieve a sustainable market return on Tenaga's assets.

The market's fundamental issue with Tenaga surrounds management's inability to adjust its product pricing to match costs, given that electricity tariffs are government-controlled while a large proportion of operating costs are market-based.

We continue to reiterate our Strong Buy recommendation on the back of undemanding valuations relative to historical PER trends and also to peer and market valuations.

Profit & Loss

FY Aug. / MYR mln	2006	2007	2008E	2009E
Reported Revenue	20,384.2	23,320.4	24,966.4	25,953.7
Reported Operating Profit	3,948.6	5,542.7	5,432.1	5,955.9
Depreciation & Amortization	-3,320.2	-3,222.0	-3,233.5	-3,271.9
Net Interest Income / (Expense)	-1,050.0	-711.3	-1,060.6	-1,081.4
Reported Pre-tax Profit	2,751.9	4,765.9	4,688.2	4,677.1
Effective Tax Rate (%)	21.4	14.7	16.0	16.9
Reported Net Profit	2,126.9	4,061.1	3,917.9	3,865.2
Reported Operating Margin (%)	19.4	23.8	21.8	22.9
Reported Pre-tax Margin (%)	13.5	20.4	18.8	18.0
Reported Net Margin (%)	10.4	17.4	15.7	14.9

Source: Company data, S&P Equity Research

Standard & Poor's Equity Research Services

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Glossary

Strong Buy: Total return is expected to outperform the total return of the KLCI or KL Emas Index respectively, by a wide margin over the coming 12 months, with shares rising in price on an absolute basis.

Buy: Total return is expected to outperform the total return of the KLCI or KL Emas Index respectively, over the coming 12 months, with shares rising in price on an absolute basis.

Hold: Total return is expected to closely approximate the total return of the KLCI or KL Emas Index respectively, over the coming 12 months with shares generally rising in price on an absolute basis.

Sell: Total return is expected to underperform the total return of the KLCI or KL Emas Index respectively, over the coming 12 months and share price is not anticipated to show a gain.

Strong Sell: Total return is expected to underperform the total return of the KLCI or KL Emas Index respectively, over the coming 12 months by a wide margin, with shares falling in price on an absolute basis.

S&P 12 Month Target Price – The S&P equity analyst's projection of the market price a given security will command 12 months hence, based on a combination of intrinsic, relative, and private market valuation metrics.

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For residents of Malaysia. All queries in relation to this report should be referred to Alexander Chia, Desmond Ch'ng or Ching Wah Tam.

Recommendation and Target Price History

Date	Recommendation	Target Price
20-Sep-07	Strong Buy	13.00
17-Apr-07	Strong Buy	16.00
26-Jan-07	Strong Buy	15.00
13-Oct-06	Strong Buy	12.00
17-Jul-06	Buy	10.90
25-May-06	Strong Buy	11.00
18-Apr-06	Buy	9.70
26-Jan-06	Buy	12.15
28-Oct-05	Buy	11.50

