The Edge Financial Daily

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Gas Malaysia in consultation for risk compensation

Gas Malaysia Bhd (March 28, RM2.40)

Maintain reduce with an unchanged target price of RM1.80: We attended an analyst briefing hosted by Gas Malaysia Bhd chief executive officer Ahmad Hashimi Abdul Manap last Friday. The key takeaway was that the allowable weighted average cost of capital (WACC) for its incentive-based regulation (IBR) is set at 8%.

However, the company is still consulting with the regulator, Energy Commission, for additional revenue to compensate it for the business risks of its distribution division.

The additional revenue, which will flow directly to its bottom line if approved by the Energy Commission, will translate into an increase in the gas tariff set based on the 8% WACC.

Gas Malaysia called the increase in tariff a "retail margin". It argues that its distribution division, the entity that is involved in contracting sales with its customers, faces greater business risks than its transmission division, which maintains and develops its gas pipeline assets.

As the distribution division has few assets, the allowable WACC of 8% does not sufficiently compensate the division for its business risks, such as defaults on receivables and refusal to take contracted gas volume by the customers.

To recap, we detailed in our previous reports that IBR may include an incentive scheme to encourage Gas Malaysia to outperform the performance standards set in the IBR.

The economic incentives from the outperformance, such as savings from fewer customer defaults and lower operating costs, could be enjoyed by Gas Malaysia for several years before being fully passed on to consumers.

Retail margin is a major surprise. We are surprised that a retail margin is being considered by the Energy Commission as it is akin to the incentive, but without the need to surpass the performance standards.

While Gas Malaysia should earn a return for taking the risks in its distribution business, these risks can be removed by factoring in the expected losses arising from these risks into the IBR while Gas Malaysia be compensated only when the actual losses exceed the expected losses.

The latter approach should result in a lower gas tariff compared to the former.

The latter approach, in our view, is more aligned to the spirit of IBR and the Energy Commission's objective to minimise gas supply costs than the former.

However, our earnings forecast assumes that it will receive a retail margin that is equivalent to 1.5% of its revenue for the next 10 years as the company hopes to secure the margin from the Energy Commission for financial year 2017 (FY17) onwards.

The retail margin accounted for 34% to 38% of our FY17 to FY18 earnings per share. A lower-than-expected margin approved, if at all, is the key potential de-rating catalyst.
— CIMB Research, March 28

Gas Malaysia Bhd

FYE DEC (RM MIL)	2014A	2015A	2016F	2017F	2018F
Revenue	2,773	3,619	4,334	5,107	5,824
Operating Ebitda	256.9	191.0	200.3	263.2	256.6
Net Profit	167.6	106.1	108.4	164.1	167.9
Core EPS	0.13	0.08	0.08	0.13	0.13
Core EPS growth (%)	(2.2)	(36.7)	2.2	51.4	2.4
FD core PER (x)	18.61	29.42	28.79	19.02	18.58
DPS	0.13	0.08	0.08	0.13	0.13
Dividend yield (%)	5.37	3.40	3.47	5.26	5.38
EV/Ebitda (x)	10.74	15.13	15.08	11.77	12.32
P/FCFE (x)	10.60	49.21	na	38.45	20.92
Net gearing (%)	(35.6)	(23.9)	(10.1)	(2.2)	4.1
P/BV (x)	3.08	3.21	3.21	3.21	3.21
ROE (%)	16.6	10.7	11.2	16.9	17.3
Change in core EPS estimates (%)	-	-	(12.4)	21.3	14.2
CIMB/consensus EPS (x)	-	-	0.79	1.11	1.19

Source: Company data, CIMB forecasts