Water Utilities

Supplemental Agreement Finally Signed

OVERWEIGHT

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In line with our expectation, the supplemental agreement for the water industry restructuring and consolidation of Selangor, Kuala Lumpur and Putrajaya was finally signed last Friday, 10 July 2015. This marked the conclusion of the Selangor State Government negotiations with Federal Government. This news certainly reinforces our OVERWEIGHT stance on the Water sector. We advocate investors to accumulate Puncak for the special dividend payment of RM1.00/fd shares. As we update our earnings forecasts, roll over our valuation benchmark to FY16 and imputing higher discount to SOP, PUNCAK's TP is revised to RM3.29 from RM3.99 previously. It is however, still an OUTPERFORM call with potential upside of 18%. As for SPLASH, we expect negotiation between SSG and GAMUDA and Sweet Water Alliance on the valuation issues to resume after SSG completed the PUNCAK's SPA. Furthermore, we expect the story of NRW reduction program or pipe replacement to emerge soon. As we expect the government to gradually spend on pipes replacement rather than immediately spend aggressively, this should benefit water pipe makers over the medium-longer term.

Supplemental agreement finally signed. According to media statement issued by the office of Selangor Chief Minister, the Supplemental Agreement for restructuring and consolidation of Selangor, Kuala Lumpur and Putrajaya water services industry was signed at the Deputy Prime Minister's office last Friday, 10 July 2015. The signing of the Supplemental Agreement to the Master Agreement dated 12 September 2014 follows the conclusion of the Selangor State Government (SSG) negotiations with the Federal Government (FG). The Supplemental Agreement extends the period for completing the Master Agreement by 60 days commencing from the date of the Supplemental Agreement. The dispute over the ownership of the Sungai Semenyih and Bukit Nanas Water Treatment Plants will now be addressed separately between the Federal and State Government. **More importantly, the extension of the completion date of the Master Agreement will facilitate the completion of the SPA signed between Air Selangor and PUNCAK for the purchase the latter's 70%-owned SYABAS and PNSB.**

Puncak likely to give an extension to SSG to complete the SPA. We understand the deadline that Puncak gave to SSG after the 6th extension to complete the SPA is today. Nonetheless, with the signing of supplemental agreement, we believe PUNCAK will extend further the deadline until SSG complete the SPA within 60 days from last Friday. Recall, the total amount that PUNCAK will receive from this water restructuring exercise will be RM1.55b with all debts and water assets to be assumed by FG or PAAB.

What about SPLASH? While we do not see SSG mentioning about SPLASH in its media statement, we believe focus for now will be sealing the deal with PUNCAK. After completion of PUNCAK's SPA, SPLASH would be the only concessionaire yet to ink a deal with SSG. We believe SSG will negotiate with SPLASH's shareholders namely GAMUDA and Sweet Water Alliance to resolve their valuation issues. We expect they will reach the final conclusion soon in the near-to-medium-term. To recap, SSG has only offered them 10% of the SPLASH's book value of RM2.5b. Note that we have already factored in SPLASH's book value of RM1.0b (at GAMUDA's level) in GAMUDA's SoP-derived TP. Any downside will negatively affect our valuation. For instance, if GAMUDA is to settle its 40%-owned SPLASH to SSG at 50% below book value, our SoP would be revised downwards to RM4.84 from current TP of RM5.05.

Downstream water players could be in the limelight after restructuring? In the media statement, SSG did mentioned that it would focus on further improving the water treatment and distribution systems, in specific, to reduce the Non-Revenue Water (NRW). This statement certainly benefits the downstream players such as HIAP TECK (NR), ENGTEX (NR), YLI (NR), GKENT, and JAKS RESOURCES (NR). Nonetheless, timing and size of spending for the NRW or pipe replacement are unknown. We do not expect the government to immediately start spending aggressively to replace the water pipe in the near future. Hence, we believe this news will benefit pipe makers over the medium-long term rather than near term.

Maintain OVERWEIGHT, accumulate PUNCAK (OP; TP: RM3.29). We reiterate our OVERWEIGHT call on the water sector as we finally see the deadlock of the Selangor water industry restructuring ending with the signing of the supplemental agreement. We advocate investors to accumulate Puncak for the special dividend payment of RM1.00/fd shares. Post special dividend payment, Puncak will be left with mainly: (i) total cash balance of RM1.2b (RM2.31/share), (ii) O&G division, (iii) construction division, (iv) 290 acres of landbank in Selangor, and (v) China's water and wastewater concession assets. While we understand there will be huge earnings vacuum after the disposal of water assets, we expect Puncak to return to the black this year thanks to interest cost savings as well as pick up in earnings in its O&G and construction divisions. All in, post earnings revisions as well as rolling over our valuation benchmark to FY16, our Target Price is revised to RM3.29 from RM3.99 previously. It is still an OUTPERFORM call with potential upside of 18%. ***(refer to overleaf)***

OTHER POINTS

Post special dividend payment, Puncak will be left with mainly;

(i) **Total cash balance of RM1.2b (RM2.31/fd share).** After special dividend payment of RM534.3m, PUNCAK's cash proceeds from the water assets' disposal stands at RM1.0b. Including net cash balance of RM221.4m as at 1Q15, we estimate the group will have total net cash balance of RM1.2b. This is equivalent to RM2.31/fd shares. We believe that PUNCAK will likely to utilize this cash to invest in its existing businesses, i.e. O&G and construction. Also, on its intention to acquire plantation assets; after getting negative reaction from market, PUNCAK might re-consider plans to buy plantation assets.

(ii) **O&G business.** As of now, Puncak's O&G division only has 1 major O&G construction asset, namely Derrick Lay Barge. We estimate the group's outstanding orderbook in the O&G segment currently stands at more than RM1.0b which are mostly the Petronas (T&I jobs) that was secured in end-2013. Earnings-wise, we noticed that this segment's earnings was pretty volatile or only achieving very low margins since 2013 no thanks to its high operating costs. Going forward, to be conservative, we forecast the group's O&G segment EBIT margins to maintain as per last year of about 5.1% while revenue of about RM500m in FY15 and RM600m in FY16 on the back of estimated outstanding orderbook of RM1.1b.

(iii) **Construction business.** We understand the group currently has outstanding orderbook of about RM400m. This will last the group for the next 2 years. YTD, PUNCAK has yet to secure any new jobs versus our initial expectation of RM500m. Assuming the group does not secure any new jobs until end of the year, we expect the group to at least deliver operating profit of about RM14m per annum on the back of EBIT margins of 7% (in line with average margins for last 4 quarters).

(iv) **290 acres of vacant land mostly in Selangor.** While the group does not have any plan yet for these vacant lands, as at FY14, according to annual report, the net book value stood at RM176.9m.

(v) **China water and wastewater concession assets.** This segment is persistently making losses due to lower revenue, high operating costs and impairment. Nonetheless, book value of this segment as at 1Q15 stood at RM73.3m.

Earnings Forecasts. While we understand there will be huge earnings vacuum after the disposal of water assets, we expect Puncak to return to the black this year on the expectation of: (i) higher interest income as a result of huge cash in its book after the disposal of water assets in 3Q15, (ii) pick up in O&G earnings in 2Q15 onwards, and (iii) pick up in construction earnings in 2H15 following orderbook reaching mid stage. Hence, we adjusted our FY15 earnings forecast (now excluding discontinued operations) to RM18.9m (from RM289.9m previously) and introduce our FY16E earnings of RM28.3m.

Valuation and Recommendation. All in, post earnings revisions as well as rolling over our valuation benchmark to FY16, our Target Price is reduced to RM3.29 from RM3.99 previously. It is still an OUTPERFORM call with potential upside of 18%. Note that we assigned a higher discount to SOP of 30% from 10% previously as we have yet to see what sort of assets/business that PUNCAK will acquire.

Summary Earnings Table 2015E Before and After Disposal of Water Assets

FYE Dec (RM m)	Before	After
Turnover	1,110.3	701.4
EBITDA	512.6	44.7
PBT	398.6	32.7
Net Profit (NP)	**298.9**	**18.9**
Consensus (NP)		
Earnings Revision	n.a	n.a
EPS (sen)	72.7	4.6
FD EPS (sen)	55.9	3.5
EPS growth (%)	20.4%	-92.4%
DPS (sen)	100.00	100.00
NTA/Share (RM)	5.0	5.0
PER	3.8	60.4
FD PER	5.0	78.5
Price/NTA (x)	0.6	0.6
Net Gearing (x)	N.C	N.C
Dividend Yield (%)	36%	36%

Puncak's Summary Earnings Table				
FYE Dec (RM m)	**2013A**	**2014A**	**2015E**	**2016E**
Turnover	1,146.7	1,169.4	701.4	801.3
EBITDA	412.5	443.1	44.7	49.1
PBT	236.4	293.5	32.7	37.1
Net Profit (NP)	**200.6**	**248.4**	**18.9**	**28.3**
Consensus (NP)				
Earnings Revision			n.a	n.a
EPS (sen)	48.8	60.4	4.6	6.9
FD EPS (sen)	37.5	46.5	3.5	5.3
EPS growth (%)	-15.9%	23.9%	-92.4%	49.3%
DPS (sen)	0.0	0.0	100.00	0.0
NTA/Share (RM)	5.0	5.0	5.0	5.0
PER	5.7	4.6	60.4	40.4
FD PER	7.4	6.0	78.5	52.6
Price/NTA (x)	0.6	0.6	0.6	0.6
Net Gearing (x)	1.0	N.C	N.C	N.C
Dividend Yield (%)	0.0	0.0	36%	0.0

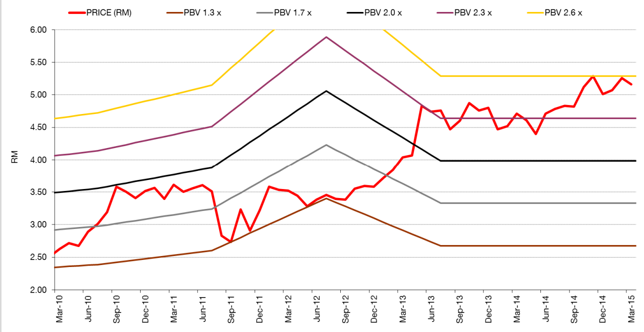
Sum Of Parts Valuation	**RM million**	**Per FD Share**	**Valuation basis and Remarks**
PNSB Equity Value	1117.5		Based on Equity Value of SSG's Offer
SYABAS (70%-owned) Equity Value	437.8		Based on Equity Value of SSG's Offer
Total Equity Value for Selangor's water asset	**1555.3**		
Special Dividend	**534.3**	**1.00**	Proposed Special Dividend
Fair Value after sale of concession assets ex-Special D			
Cash to be received after sale of water assets and Special D payment	1017.7	1.90	To be utilized for future investments
Puncak O&G Division	206.6	0.39	Based on PER of 9x FY16 earnings
Puncak Construction	229.5	0.43	Based on PER of 9x FY16 earnings
Other Assets (Landbanks and Water concession in China)	250.2	0.47	Book Value
Cash proceeds from warrants	41.0	0.08	
Total Value	1744.9	3.26	
Fair Value (after 30% discount)	**1221.4**	**2.29**	
TARGET PRICE (RM/share)		**3.29**	

SSG Offer to PUNCAK	**RM million**
PNSB Equity Value	1117.5
SYABAS (70%-owned) Equity Value	437.8
Total Equity Value for Selangor's water asset	**1555.3**

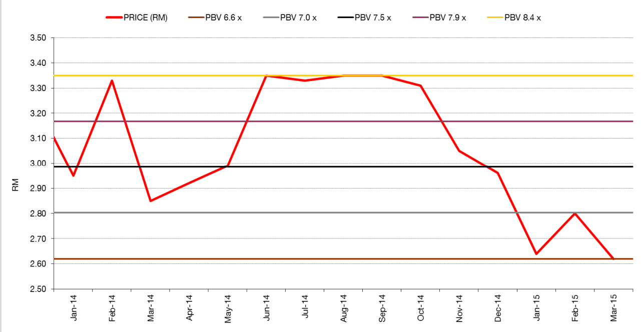
Description	**RM million**	**Timeframe for the utilisation of proceeds**
Future investments	1017.7	Within 12 months
Distribution to shareholders of PNHB	534.3	Within 3 months
Defraying expenses incidental to the Proposed Disposals	3.3	Within 2 months
Total	**1555.3**	

UTILITIES FWD PBV

Fwd PBV: GAMUDA



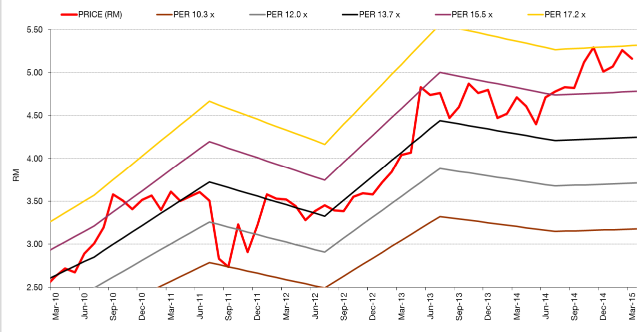
Fwd PBV: PUNCAK



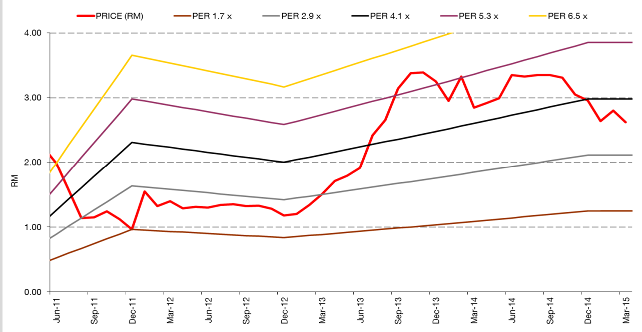
Source: Kenanga Research

UTILITIES FWD PER

Fwd PER: GAMUDA



Fwd PER: PUNCAK



Source: Kenanga Research

Peer Comparison

WATER STOCKS

NAME	Price	Mkt Cap	PER (x)			Est. Div. Yld.	Est. ROE	P/BV	Net Profit (RMm)			1 Yr Fwd NP Growth	2 Yr Fwd NP Growth	Target Price	Rating	YTD (%)
	(RM)	(RMm)	Actual	1 Yr Fwd	2 Yr Fwd	(%)	(%)	(x)	Actual	1 Yr Fwd	2 Yr Fwd	(%)	(%)	(RM)		
PUNCAK NIAGA HOLDINGS BHD	2.78	1156.4	4.7	61.2	40.9	36.0	0.9	0.6	248.4	18.9	28.3	-92.4	49.7	3.29	Outperform	-6.1
GAMUDA BHD	4.82	11596.5	16.3	16.9	16.7	2.5	14.3	2.4	712.3	687.2	694.3	-3.5	1.0	5.05	Market Perform	-3.8
ENGTEX GROUP BHD	1.2	355.4	8.1	6.1	6.5	1.3	12.5	0.8	43.6	58.0	55.0	32.9	-5.2	1.68	Take Profit	8.1
HIAP TECK VENTURE BHD	0.38	267.3	5.9	23.2	6.7	0.8	-0.2	0.3	45.6	11.5	39.7	-74.7	244.5	n.a.	Not Rated	-35.3

Source: Kenanga Research

Stock Ratings are defined as follows:

Stock Recommendations

OUTPERFORM	: A particular stock's Expected Total Return is MORE than 10% (an approximation to the 5-year annualised Total Return of FBMKLCI of 10.2%).
MARKET PERFORM	: A particular stock's Expected Total Return is WITHIN the range of 3% to 10%.
UNDERPERFORM	: A particular stock's Expected Total Return is LESS than 3% (an approximation to the 12-month Fixed Deposit Rate of 3.15% as a proxy to Risk-Free Rate).

Sector Recommendations***

OVERWEIGHT	: A particular sector's Expected Total Return is MORE than 10% (an approximation to the 5-year annualised Total Return of FBMKLCI of 10.2%).
NEUTRAL	: A particular sector's Expected Total Return is WITHIN the range of 3% to 10%.
UNDERWEIGHT	: A particular sector's Expected Total Return is LESS than 3% (an approximation to the 12-month Fixed Deposit Rate of 3.15% as a proxy to Risk-Free Rate).

******Sector recommendations are defined based on market capitalisation weighted average expected total return for stocks under our coverage.***

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