FIRST METRO
INVESTMENT CORPORATION
Metrobank Group

15 Feb. 2014
Volume 2 No. 2

The Bellwether

Fortnightly on Market Action and Outlook

STOCK WATCH

MERALCO

▶ WILL REPLACEMENT POWER MITIGATE THE POWER RATE HIKE?

energy DEVELOPMENT CORPORATION

▶ EDC'S LEYTE IS UP AND RUNNING

No Worries on China's Debts

Timing is Significant

China's growth is not what it used to be. The ten-year average GDP of 10% (2000-2010) is now a lower three year average of 8.2%, (2011-2012). Last year's growth of 7.7% may slow further to 7.4%, the bet of most economists. Though this is not news anymore, its timing is significant.

China hardlanding risks are vis-a-vis deepening doubts the global economy is not as strong as when the year opened. Risks to global growth abound:

- *rising interest rates in the US or the Fed taper,*
- *hasty interest rate hikes in major developing countries such as Turkey, India, and South Africa*
- *tumbling emerging market stocks,*
- *and what the Wall St Journal called "whispers of disappointment in US corporate earnings calls.*

On an Even Keel

If China slows, because it is changing its growth model and cooling its hot property sector, the fear is it may trigger a banking crisis. Worrisome elements are present in China at a time of growing global risks. There was rapid debt growth that fueled a property boom and built up bank balance sheets. There is an unregulated shadow banking industry that grew to half of the entire banking industry. While the fears have bases, there are also risk mitigants related to strong China economic fundamentals –fiscal and external position strengths -- that can put it on an even keel.

Debt and Loan Default

The nerves were about China's fast-paced debt growth that mimmicked the pre-property bust Japan (1990) and pre-Lehman bust US, (2007). China's $6.0 trillion shadow banking that has grown five times since 2007 and now 75% of China's GDP of $8.2 trillion recently had its first high-profile loan default involving $496m, but got restructured by a government bailout. This was the ICBC-sold investment trust whose funds went into a coal mining company that went bankrupt. That this default happened is a symptom of banking regulation being way behind the curve and one that does rely on market forces but more on the government's hand, e.g. state intervention.

Dangers

A strong government hand raises two dangers. Yield-seeking investors won't learn the true risk of wealth management products sold by investment trust because bailouts ensure the safety of their principal. They will patronize and help shadow banking to thrive. Second, the last three instances of credit crunches that sent interest rates to recent highs in panic-stricken Chinese financial markets were blamed on the clumsiness of China's anti-shadow banking clamp down that were not market-based. Chinese authorities had intended to punish shadow banking by creating artificially higher interest in the money market. Investors questioned whether this way the right way to police shadow banking?

Strong Fundamentals

On the other hand, if China's financial statistics were to be believed despite data integrity issues, the country's fundamentals seem strong enough to withstand emerging cracks in the financial system. China's shadow banking may be rapidly growing but its small compared to the other economies, according to the Financial Stabilization Board (FSB). See Note 1 on FSB below. Despite the fact that shadow banking assets have decreased slightly since 2008, the global figure in 2011 was $68 trillion. China has a miniscule share of just 12%. In terms of geographical distribution, the biggest share is concentrated in the United States (around $23.6 trillion, 23.63%) and in Europe (Eurozone with $22.68T and the United Kingdom with around $9.18T).

MERALCO

Manila Electric Compay (MER)

Will Replacement Power Mitigate the Power Rate Hike?

MER Stock Data	
Price (PHP)	253.00
Market Cap (PHP Bn)	286.16
Outstanding shares (Bn)	1.13
PE (X)	15.89
Price to Book (X)	4.07

Source: Bloomberg

Far From Reducing

Meralco may have reported a lower generation charge of PHP5.54/kwh for February, signaling the normalization of the power supply in the Luzon grid, but its generation cost under recoveries are far from reducing. Just for the month of January, Meralco reported a PHP10.22/kwh generation charge billable to customers, but this won't pass the entire amount (only P5.67/kwh) in light of the High Court's temporary restraining order (TRO) on any generation cost increases above the peg (PHP5.67/kwh) which the judiciary has effectively set.

Short-lived Normalization

Also, this so-called power supply "normalization" may be short-lived with Malampaya scheduled to be on shutdown anew next month for further pipe unclogging. Market talk had it that Malampaya's "repairs" are not a simple as they sound.

The 483km underwater natural gas pipeline from Palawan to Batangas has become structurally impaired and "moving." Also, the Luzon grid will be short by 80MW this summer due to the rising peak demand of a robustly growing economy, according to the DOE.

Cash Flow Impact Doubles

The cash flow impact -- earlier estimated to be PHP9.2bn (by Meralco's own CFO B. S. Yap) -- on the initial PHP4.15/kwh increase for December (but frozen by the TRO) will double given the higher increase that must be collected worth Ph4.55/kwh last January. The initial rate hike was supposed to be billed in three tranches, last December, January, and March 2014. For its growing pass through cost liabilities to the power suppliers (the generation companies) with which it has existing power supply agreements (PSAs), Meralco's policy in light of the TRO has been not to remit what was not collected. That means the gencos' receivables from the customers (rising generation charges which are pass through costs in Meralco) have begun to pile up.

Caught in a Cash Squeeze

Representatives from the gencos Aboitiz Power (AP), Energy Develpment Corp. (EDC) and First Gen Corp. (FGEN) have informed a Senate public hearing chaired by Senator Serge Osmena two weeks ago that they have not reached an agreement with Meralco on the latter's policy of " no remit, no collect." Caught in a cash squeeze, the genco's position was that Meralco has an existing liability with them that must be remitted. Up to what extent these uncollectibles wreak havoc on the gencos' financials is something that would later on show in the 1Q14 results.

Is Replacement Power the Answer?

Meanwhile, the Dept of Energy's initiative to arrest future WESM price spikes and generation cost increases by requiring power plants, Meralco, and other distribution utilities (DUs) to include a replacement power provision in their PSAs will only increase generation cost. This was made clear by Meralco President Oscar Reyes in a Senate public hearing on the Meralco power rate hike and echoed to us by the Meralco IR.

If the PSAs are structured to include additional risks to be borne by the gencos in terms of replacing the power supply to Meralco (other DUs) in case of plant shutdowns, then generation cost will have to reflect this, which is higher and not lower. Meralco hopes this does not work retroactively as it has just closed 5-year and 7-year PSAs with several gencos last year.

The question is why should the gencos and Meralco be made to bear costs that are by "jurisdiction" better cured by a more aggressive NGCP's reserve power stocking and timely dispatch of PSALM's peaking plants? ▲

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energy
DEVELOPMENT CORPORATION

Energy Development Corporation (EDC)

Leyte Is Up and Running, Ahead of Expectation

EDC Stock Data	
Price (PHP)	5.30
Market Cap (PHP Bn)	99.38
Outstanding shares (Bn)	18.75
PE (X)	14.52
Price to Book (X)	2.86

Source: Bloomberg

Ahead of Investor Expectations

Half of EDC's Yolanda-damaged Unified Leyte (UL) was already up and running as of last month at 369MW of the 700MW installed capacity. The timing and scale of the recovery was way ahead of investors' expectation, which was only 171MW up and running at most for the entire 2014. The news and its positive consequence on earnings was a pleasant surprise that pulled EDC share prices, up 22% from its lowest point of PHP4.37/share in the aftermath of Yolanda last November 21 to the current level of PHP5.37/shr.

Volatile Earnings and Rising FX Losses on Weak Peso

EDC's earnings were, by its funding structure and sales contract, inherently volatile, and the UL damage has added to the uncertainties.

- It has WESM exposure through its 132MW FGHydro;
- Its tariffs are dropping (Leyte and Mindanao contracts);
- Fx losses are inherent in the PHP20bn equivalent outstanding dollar loan against a depreciating peso.

The 9M13 results had shown EDC's vulnerabilities; earnings were a third lower to PHP5.9bn versus 2012 due to foreign exchange losses of PHP901mn, lower billed volumes of UL and Mindanao, and weaker selling prices of 60%-owned FG Hydro (co-owned by FGEN) that chipped off 8% of electricity sales to PHP19.8b for the period.

EDC's Handicaps

EDC has been handicapped by the damaged UL plant since late last year. That's on top of the prolonged 130MW Bacman plant rehab, which will be repaired and retrofitted (full part replacement for the two units, 50MW each) and then recommissioned by early 2015. UL is significant, making up 61% of EDC's 1,148MW installed capacity.

Above Peer Average Leverage

There is another downside to EDC. Over the past years, it has remained highly leveraged, with a debt-to-equity ratio of 1.5x, higher when compared to parent FGEN's 1.45x, Aboitiz Power's 0.44x and San Miguel Global Power's 1.05x. Regional peer average debt to equity ratio stands at 1:1 based on Bloomberg.

UL-related Lost Sales Ease

We estimate lost income of UL won't be as great as earlier estimated at PHP2.7bn involving 3bn KwH lost sales in 2013, if UL were to run at only 171MW the whole year. That estimate assumed a selling price of PHP3.60/KwH (2012 guidance) with a net margin of 25%.

Recent guidance on UL's electricity selling price is a lower PHP3.00/KwH. If half of UL were to be operational this year -- which is the current scenario and will most likely last for the rest of the year -- only 2bn KwH sales of electricity will be lost (of the yearly normalized 4bn KwH sales). Net margin is 25% for both scenarios.

Foregone earnings will be reduced to PHP1.5bn, which leads to a better income scenario of PHP5.5bn for the entire year, above the PHP4.3bn under the 171MW capacity. Note that the pre-UL 2013 EDC earnings guidance (without Bacman) was PHP7bn.

Net of the UL impact, 2014 earnings is PHP5.5bn. PE at the revised earnings is high at 18.5x, way above the PE of 15x based on Bloomberg's higher PHP6.2bn 2014 earnings.

PHP9bn Debt Matures in 2015

With regards to EDC's biggest PHP9bn debt maturities next year plus interest expenses of PHP4bn (7.1% on PHP56bn debt), this is likely to be taken care of by its PHP15bn cash on hand or by a refinancing. There is also an undisclosed portion of the PHP3.3bn insurance claim due to UL's damage and potential 2H14 earnings impact of the scheduled commissioning of 20MW Nasulo geothermal and 85MW Burgos wind project this year adding to cash. There is still no earnings estimate but selling prices are estimated at PHP8.53/KwH for the wind project and PHP4.70/KwH for the geothermal unit.

EDC's trailing 12 months operating cash is PHP13bn; less the UL impact nets EDC with around PHP11.5bn. Total cash (on hand and from operations less the UL impact) thus is PHP26.5bn, and can adequately cover this year's PHP7.6bn in combined debt maturity (PHP1.6bn), interest expenses (PHP4bn) and dividends of a third of previous year's earnings or PHP2bn (i.e. PHP0.11/share). Recall that EDC paid PHP0.16/shr in 2012 as dividends.

After all the abovementioned are paid, we estimate EDC will still have excess cash of PHP18.9bn for capex this year. EDC's capex is trending up and is likely to stay up with the full restoration of UL and Bacman, and the expansion in South America. Programmed capex reached a high of PHP32bn last year (operating and expansion) from a booked capex of PHP7bn in 2012 and PHP9bn in 2011. It is likely EDC will refinance the PHP9bn debt maturities, lower its dividends and borrow some more. ▲

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SAN MIGUEL CORPORATION

San Miguel Corporation (SMC)

Ready for 14.2km Skyway III

SMC Stock Data	
Price (PHP)	55.50
Market Cap (PHP Bn)	131.92
Outstanding shares (Bn)	2.38
PE (X)	13.25
Price to Book (X)	0.54

Source: Bloomberg

San Miguel Corp. (SMC) is ready to start building Skyway III and merely awaits the government's go signal.

The Skyway III Project, awarded to SMC late last 2013, is a 14.2km toll road costing PHP30bn. It will link -- through mostly elevated tracks -- the South Luzon Expressway (SLEX), the 16.8km Skyway I (Buendia to Bicutan) and 9.3km Skyway II (Bicutan to Alabang) with the North Luzon Expressway (NLEX) Balintawak. Skyway III connects Buendia Ave. with Quirino Highway and passes through Plaza Dilao, Paco, Aurora Avenue, E. Rodriguez Ave., and Quezon Ave to NLEX Balintawak.

Toll road income is equity earnings for SMC through 46%-owned Atlantic Aurum which, in turn, owns 87% of Citra Metro Manila Tollways Corp. (CMMTC). Skyway I, II and SLEX and the SLEX O&M Company (SOMCO) make PHP10bn in yearly revenues with a huge EBITDA margin of 70%. We learned that its baseline project return rate is 15%. SMC also plans to extend SLEX to Lucena, then to Bicol.

Its 86km toll road in the north, TPLEX (from Tarlac to Carmen, Pangasinan), is half-finished, and has been contributing to toll road income (value undisclosed). The other half stretch of TPLEX will be finished in two years. With the completion of TPLEZ and along with NAIA Expressway, SMC's toll road business will be the country's most extensive if the planned SLEX routes to Lucena and to Bicol materialize.

SMC's strategy has been to integrate existing businesses, starting with Global Business Power extending to the development of fuel sources, coal mining.

In fuel, it is has extended Petron into the upstream petrochemical business through the acquisition of a polypropylene plant and forward into petrol reselling stations, a network of 3,000 by 2015. Petron bought a refinery in Malaysia and 500 reselling stations tucked into that company (Esso Berhad and subsidiaries).

Its food business, Purefoods, has a contract growing component in hogs and chicken. It sources the latter's feeds from another subsidiary, BMEG, and has processed foods that are strong market brands.

SMC's biggest losing business continues to be flag carrier PAL with a PHP3.2bn net loss in latest fiscal year. ▲

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China's Debts, from Page 1.

China's total debt (to financial institution, households, firms and persons) have grown to 216% of its $8.2T GDP or $17.7T in total. The risk mitigant is that the central government debt accounts only for 39% of GDP. Inclusive of the local gov't (LG) debt (LGD), the percentage rises to 51%. Fitch, which cut China's long-term local currency credit rating to A-plus from AA-minus in April, estimated then that China's government debt was equivalent to 49% of GDP. At 58 percent of GDP, China's total debt is a long way from Japan's 240 percent and Greece's 160 percent, ANZ data showed. The budget deficit is also small in China and so is its foreign debt, 7% and 17% of GDP, respectively. Low foreign debt and its currency peg that trades on a guided narrow band help to reinforce China's strong shield against externally-rooted currency contagion risk. Maturing debts this year at slightly above $427b is also small compared to the $3.3trillion foreign exchange reserves of China.

Greater Stake

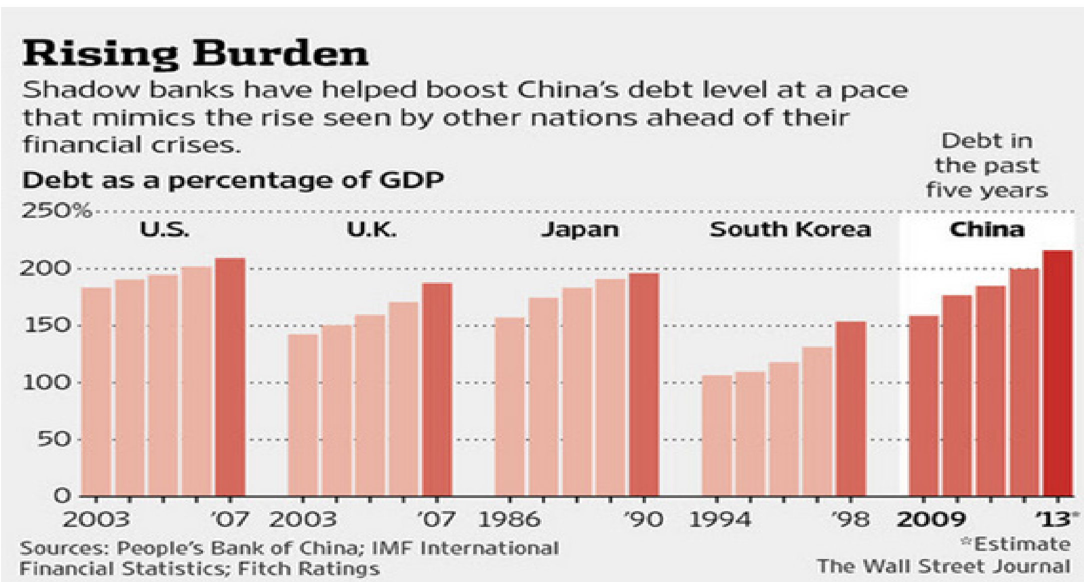
Government's softpedalling on shadow banking could also mean the stakes could actually be higher. There is a portion of the local government loans that are intractable as they are from the "shadow banking" industry and could cause trouble to the entire system. $2.9T of the total LGD is from the shadow banking industry. These were part of the LGs' borrowing spree that have built bridges, roads and infrastructure that sometimes lead to nowhere, (non-viable, unprofitable projects) and don't really contribute to the overall productive capacity of the economy. An ongoing national debt audit could indicate that China's local government debt almost doubled in about 2-1/2 years. The most pessimistic market estimates of what local governments owe have been close to $4.1 trillion.

LGs as Huge Spenders and Borrowers

Under China's laws, local governments are barred from borrowing directly from banks or investors to protect the country's fiscal health. Yet despite not being able to borrow, local authorities are responsible for most of China's public spending but take only half of fiscal income. Local governments in 2010 received 48 percent of total fiscal income but were responsible for 80 percent of public spending. The funding shortfall has forced local authorities to set up firms over the years to borrow on their behalf, leading to a rapid rise in government debt outside official balance sheets. What is the way out?

Merrill Lynch-Bank of America said Beijing should aim instead to pick up some of the debt burden from local authorities, and replace short-term borrowings with longer-duration loans. To maintain both economic growth and financial stability, China should avoid simplistic deleveraging and debt reduction.

Note 1. The Financial Stability Board (FSB) is an international body that monitors and makes recommendations about the global financial system. It was established after the 2009 G-20 London summit in April 2009 as a successor to the Financial Stability Forum. The Board includes all G-20 major economies, FSF members, and the European Commission. It is based in Basel, Switzerland.



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