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HD **Utilities: not necessarily a power play**

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The electricity, water and gas sector is a hodgepodge of unsexy names and hot **China** stocks, reports CAI HAOXIANG

FOR retirees who are looking to invest their money, or for a risk-averse person just starting out, a common question will be: What are the stable stocks in the market? Not everyone is interested in chasing the latest technology initial public offering (IPO) that might be up 10 per cent one day and down 15 per cent the next. Rather, it is the counter that gives steady returns of 5-8 per cent a year that might be more appealing.

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Returns like these are nothing to sniff at when compounded over the long term. Assets that deliver 7.2 per cent a year, for instance, will have doubled in value over 10 years.

What businesses offer the lowest risk in the market? In theory, the providers of utilities such as electricity, water and gas fall under this category.

After all, these businesses often enjoy a government-sanctioned monopoly, or might themselves be partially owned by the government. Their revenue-generating assets - electricity lines, water treatment plants, gas pipes, waste treatment plants - cost a lot to build, and there is no danger of rivals setting up alternative networks anytime soon.

Income could be guaranteed by regulation, with prices fixed in advance for many years. This makes future earnings easy to calculate. Moreover, the nature of the products provided makes the business less vulnerable to economic shocks. During a downturn, companies and people may cut back on investment or big-ticket consumer goods such as new cars, but they will continue to leave the lights on and pay for water and cooking gas.

The medium-term growth story is also looking good. Market research **company** Frost & Sullivan noted in a recent report that rising electricity demand, regional economic growth and falling **coal** prices mean that the power generation industry will see continued investments. The **company** noted in another report that the water industry is resilient as it supports socioeconomic activities.

But companies need to constantly reinvent themselves to stay ahead, while being prudent with their investments. "It is not uncommon that water companies become too ambitious in taking up projects that do not match their core competencies, and this may **lead** to unnecessary financial damages and divestments," the report said.

In Singapore, the utilities sector contains a hodgepodge of the unsexy but high-performing Sembcorp Industries, electricity distributor SP AusNet, sizzling-hot **China** stocks such as SIIC Environment and HanKore, counters with trust structures such as K-Green Trust and Cityspring Infrastructure Trust, and home-grown multinational Hyflux.

While the theory of investing in the utilities sector sounds good, the reality is quite different. An examination of the various utilities companies listed here can illuminate.

For one thing, prices may be guaranteed but demand is not. The recent unusually cool tropical weather in Singapore might mean less demand for electricity for air-conditioning and fans, for example.

Also, some utilities companies have a business model where they bid for projects and then develop them. Hiccups in the process can incur large expenses. The number of projects that they tender for may also fall in the event of global economic uncertainty.

Eventually, the certainty of income flows at prices fixed by governments fades away as concession agreements expire after 20 to 30 years. Investors should ask what happens next.

Another macroeconomic event to watch out for is rising interest rates as the US Federal Reserve slows down its bond-buying programme on an improving US economy. Utilities companies may pay a seemingly high yield now, but rising interest rates will make that yield less attractive, causing their valuations to fall. Moreover, many companies have to take out large borrowings to fund their expenditures in building power plants or water treatment plants. Rising rates mean a higher cost of debt, which might put the **company**'s solvency in doubt in the event of a downturn.

High yields, therefore, are not everything. A part of dividends paid may come from the return of the initial investment of a **company**, called the "return of capital". This is not real income but effectively a transfer of value from companies to shareholders, but non-savvy investors might mistakenly treat it as a flow that will continue forever.

Investors also need to examine the nature of the financial vehicle that they are buying, as utilities companies may be listed using opaque trust structures.

Finally, investors can consider diversifying by buying a range of utilities companies in an exchange-traded fund (ETF). Both the Vanguard Utilities ETF and the iShares US Utilities ETF, for example, have had annual average returns of more than 8 per cent for the last 10 years.

Total returns in this piece were all calculated by Bloomberg and are based on monthly returns, and assuming that dividends are reinvested into the stock.

Sembcorp Industries and SP AusNet

Over a longer-term horizon, the star in Singapore's utilities sector has been the largest stock there, Straits Times Index (STI) component Sembcorp Industries. If dividends are reinvested, Sembcorp has generated yields of 20 per cent a year on average each year in the last 10 years, according to Bloomberg. This is due to both its marine and utilities businesses.

The utilities business of Sembcorp Industries is currently its largest and most profitable segment, apart from its also-sizeable marine segment. Sembcorp develops, owns and operates **energy** and water assets. Sembcorp serves industrial and municipal customers, generating power, supplying steam and natural gas, treating wastewater as well as providing desalinated and drinkable water.

Net profit from its utilities segment has grown steadily in the last five years from $202 **million** in 2008 to $375 **million** in 2012. In its latest earnings report in Nov 11, 2013, Sembcorp said that the utilities business should perform better for the full year despite greater competition in the Singapore gas and power market. Meanwhile, the **company** has a pipeline of projects in Singapore, India, the United Arab Emirates, **China** and the United Kingdom.

Sembcorp distributes dividends annually with ex-dates at end-April. Ordinary dividends in the past four years have been 15 cents a share, with bonus dividends of two cents in 2010 and 2011. At 15 cents a share, this translates to a yield of 2.8 per cent on its last traded price of $5.30.

After Sembcorp, the next largest utilities counter in Singapore is Australian utilities provider SP AusNet, which is 31-per cent owned by a unit of Temasek Holdings-held Singapore Power. It distributes electricity and gas in the south-eastern Australian state of Victoria, and has a secondary listing in Singapore.

Last November, it declared an interim distribution of 4.18 Australian cents (4.65 Singapore cents) per security, out of which 0.391 cent, or almost a tenth, is a "return of capital". Distributions are expected to be 8.36 Australian cents per security for the full year, or a yield of 6.9 per cent on its last traded price of A$1.205.

For its half-year results ended Sept 30, 2013, revenues were almost A$1 **billion**, while net profit was close to A$100 **million**. Net profit would have been higher if not for A$87 **million** that the **company** would have to pay after Australian courts ruled against it in a dispute with the Australian Taxation Office. SP AusNet is appealing.

A bit of historical trivia here - SP AusNet was the first stapled security to list in Singapore in 2005. This is a structure common to property and infrastructure companies in Australia where two separate legal entities are bound together. This allows the company to distribute cash as well as gives it more more flexibility when carrying out future acquisitions, SP AusNet has said. But while giving tax advantages to owners, these structures can be opaque and give investors limited control rights, and the real advantages to minority investors are unclear, according to an article by the non-partisan Australian Centre for Financial Studies.

SP AusNet's eight-year average return was 8.7 per cent a year.

Hyflux

Another utilities company that Singaporeans might be familiar with is homegrown water treatment company Hyflux. Its executive chairman Olivia Lum won many awards for her entrepreneurship.

The company started out as a distributor for water treatment equipment, eventually branching out into designing, building and running custom-made water treatment systems. It went public in 2001 and went on to clinch various key projects here and around the region, including the construction of Singapore's first desalination plant, as well as its first Newater plant. The second, called Tuaspring, opened last September. It is also involved in a major desalination project in India.

Hyflux employs 2,400 people around the world, according to its 2012 annual report. Its annual revenues have grown from around $10 million at its IPO to $682 million in 2012. Its order book at end-2012 was almost $3 billion.

Hyflux's 10-year return was 6.9 per cent a year on average.

Indonesian plays: Gallant and ISDN

Gallant Venture is a utilities and industrial park provider in the Indonesian islands of Batam and Bintan. It also owns a smaller resorts business, Bintan Resorts. It also has a property development component.

In end-2012, the company bought into vehicle distributor PT Indomobil Sukses Internasional Tbk (IMAS), which manages brands such as Audi, Nissan, Renault, Suzuki, Volkswagen and Volvo.

While the vehicle distribution acquisition boosted revenues and profits, the outlook for Gallant's core business is not as bright. "The industrial park and utilities business remain challenging, and electricity consumption remains depressed," Gallant wrote in its Nov 1, 2013 third-quarter results. "With increasing labour cost, high fuel cost and potential surcharge on gas purchases, the industrial parks' and utilities' margin will be impacted."

ISDN Holdings, an engineering solutions provider, could also be an interesting utilities play to watch. It is diversifying into energy projects in the region. It is planning to develop a string of mini-hydropower plants in Indonesia. A plan to develop the largest coal power plant in Myanmar is also in the works.

Gallant Venture's 7.5-year return was negative 8.6 per cent a year, according to Bloomberg.

Meanwhile, ISDN shares shot up more than three times last year, with its price up 10 times at one point. This boosted its eight-year return to 14 per cent a year.

K-Green Trust, Cityspring

Then there are a couple of companies with business trust structures.

K-Green Trust was spun off by conglomerate Keppel Corp in 2010 as a vehicle comprising the Senoko Waste-to-Energy Incineration Plant, the Keppel Seghers Tuas Waste-to-Energy Plant and the Ulu Pandan Newater Plant assets. The term of agreements entered with authorities for the assets to operate is from 15 to 25 years. It has not made any new acquisitions yet.

The trust said on its website that it has potential for long-term capital growth, as it will invest in green infrastructure assets in Singapore and globally. These assets operate under long-term agreements, have a competitive advantage because they are difficult to replicate, and also enjoy inelastic demand.

But assets may have a finite life, and investors have to value them by their projected cash flows over that life, instead of assuming that flows will continue forever. K-Green Trust pays dividends partially out of declining "service concession receivables", which are rights to receive fixed or determinable payments from the National Environment Agency and national water agency PUB.

Thus some observers have been critical of the trust, pointing that investors should not just look at the trust's yield alone. AmFraser Research, which maintained a "sell" call on the trust last Tuesday, pointed out that its then-7.4 per cent yield masks a partial return of capital - essentially the trust drawing down on its assets to pay back investors, instead of earning an additional return on those assets.

Cityspring Infrastructure Trust, meanwhile, is involved in several utilities activities. Wholly owned subsidiary City Gas produces and supplies town gas in Singapore. Cityspring's gas **operations** are the trust's biggest revenue and profit contributor. Meanwhile, a 70 per cent owned unit, SingSpring, is the first desalination plant that Hyflux built in Singapore. Hyflux currently owns the remaining 30 per cent of SingSpring.

Wholly owned Cityspring subsidiary Basslink owns and operates a 370 km underwater power cable linking mainland Australia with the Tasmanian island. Basslink owns Basslink Telecoms, which provides telecommunication services between Hobart in Tasmania and Melbourne on the mainland.

Wholly owned Cityspring subsidiary CityNet owns, installs, operates and maintains the assets of NetLink Trust - a unit of telco giant SingTel that recently bought OpenNet, Singapore's ultra-fast fibre broadband network.

Cityspring currently pays a 6.9 per cent yield, according to Bloomberg. Despite the apparent strength of Cityspring's assets, its stock price performance has been uninspiring especially for those who have bought the shares since its IPO. Shares have been languishing below 50 cents for much of the past two-and-a-half years, a fair distance from its IPO price of 89 cents or its adjusted IPO price of 69 cents after rights issues.

Cityspring's five-year performance according to Bloomberg was 12 per cent a year, while its seven-year performance was about negative 5 per cent a year.

K-Green Trust has five-year returns of about 5 per cent a year.

ART Home-grown: Hyflux executive chairman Olivia Lum - who has won many awards for her entrepreneurship - at the **company**'s Tuaspring desalination plant. - THE STRAITS TIMES FILE PHOTO

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