Where your energy money goes

Investing in SET's biggest sector means placing a heavy bet on PTT, the government and the price of oil

ALEXANDER WOOD

After generating total shareholder returns of around 70% in 2007 (according to PYI figures), by year-end, Thailand's listed energy sector (including petrochemicals) had a total market capitalisation of around 2.5 trillion baht.

That's equivalent to approximately 40% of the total equity capitalisation of the entire Thai stock market. What if an investor decided to make an investment in the Thai listed energy sector at around year end 2007 with allocations weighted in accordance with market capitalisations? What would he/she be betting on?

To keep the explanation relatively simple, let's start by imagining that the investor decided to invest just 25 baht (in line with the sector's 2.5-trillion-baht capitalisation).

The first observation is that the investor would be putting about 22 baht (or nearly 90% of his money) into the PTT corporate empire, which, of course, in turn, is controlled two-thirds by the government. So, pretty much, you'd be putting your money ultimately in government hands — and linking your fortunes to oil in some shape or form.

Secondly, about six baht of this 22 baht in the PTT empire would actually be double exposure via PTT itself to five listed refining and petrochemicals companies and one upstream company.

Thirdly, about four baht of the total 25 baht invested in the "Thai" listed energy sector, would in fact be a bet on overseas oil, gas and coal assets (mainly in Burma and Indonesia).

The full breakdown of the investor's 25 baht would be roughly as follows:

✦ **Nine baht in refining and petrochemicals:** Direct exposure worth about 6 baht to a handful of listed refining and petrochemicals companies (Thai Oil, IRPC, Bangchak, IRPC, PTTAR and PTT Chemicals) and a second level of investment, worth just under three baht, in the same companies through PTT itself (which has shareholdings of between 25-50% in these companies); note that 2008 has brought another refinery listing, Esso, and should see one more with SRPC's flotation later this year (which also has a PTT shareholding).

✦ **Nine baht in upstream oil and gas:** Direct exposure worth just over five baht through PTTEP and a doubling-up, of just under another four baht, through PTT (PTT owns 67% of PTTEP); about seven baht of this is upstream natural gas exposure, and about two baht is crude oil; also about a third of the overall value (so about three baht) is effectively exposure to foreign upstream fields such as Yetagun, Yadana and M9 in Burma and 16-1 in Vietnam; PTTEP has interests in nearly forty E&P projects worldwide, including North Africa, the Middle East, South-East Asia and Australia/NZ; about one-third of PTTEP's proved reserves (just under a billion barrels of oil equivalent) are overseas.

✦ **Four baht in midstream gas (and oil):** Through PTT, investment in its core gas transmission and gas separation plant businesses (which do not have a separate listing) as well as its oil marketing and trading businesses; note that many analysts value PTT's midstream gas business at nearer six baht (i.e. around 600 billion baht) using discounted cash flow methods.

✦ **Two baht in power generation:** Exposure to around 9GW out of Thailand's 30GW of generating capacity through investment in RATCH, EGCO, GLOW, BANPU and a couple of others; note a small doubling-up effect through Banpu's 15% in RATCH and exposure to BLCP (1.4GW coal-fired) 50/50 through investment in Banpu and EGCO.

Note also that there is very little exposure to power assets outside Thailand (probably less than 10 satang of value, mainly in Laos, with just a taste of China through Banpu's interests there) — and hardly any exposure to renewables, probably not much more than one satang (mainly through Solartron).

✦ **One baht in coal-mining:** Principally in Indonesian export-grade coal, primarily through Banpu's 74% share in Jakarta-listed ITM, and to a much lesser degree through Lanna; investment in Banpu also provides some exposure to the Chinese, Lao and Thai coal sectors, though not much (China coal is still small for Banpu, Laos is still a project through Hongsa and the Thai coal mines are being closed).

What parts of the Thai energy sector would the 25-baht investment **not** give exposure to?

The short answer is: around two-thirds of Thailand's upstream oil and gas production (largely controlled by Chevron and other international players), about 10% of Thailand's refining capacity (until SRPC is listed), more than half of Thailand's power generating capacity — and nearly all lignite mining output (Egat's privatisation having been cancelled twice).

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Some great companies are overlooked because analysts don't understand them.

Five simple steps to create and manage shareholder value

Identify what makes your business valuable, then manage to create consistent growth

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Ideally, the main objective in managing a public company should be to "maximise shareholder value". I assume most top management of public companies understand and know that in order to "create and/or maximise shareholder value", a company needs to consistently generate return, e.g. TSR, that are greater than company's required rate of return. However, many times and in many cases, top management do not understand that it is within their power to manage this value.

In his article, Alexander Wood has emphasised the importance of Investor Relations — communicating well with the capital market in order to achieve in "fair value". Apart of this, there are two other components that top management can influence in order to create and manage shareholder value.

First, management should focus on its asset strategy, because the engine of value creation at the company is its asset and investment strategy. Leaders should focus around the company's core skills and competitive advantages and where these can be used in areas with significant value growth potential.

Second, management can manage value through financial strategy. Financial resources should be directed to and aligned with strategic focus of the company. However, in many circumstances, financial resources are directed to a project that does not support company's strategy and/or create value to the firm. Poor financing decisions can hold back shareholder value growth through lack of capital, high transactions costs, etc.

These three components — asset strategy, financing decision, and investor relations — are key components to manage and create shareholder value.

How can top management effectively utilise and align these components to maximise shareholder value? I have extracted five simple steps to help management create and manage shareholder value as follows:

1. Identify the value of the firm and understand what drives value for a particular company. Numerous times I have been in discussions with CEOs and CFOs of public companies and have been surprised to find that they are unsure of the truth worth of their company. Many executives simply look at the company's P/E and compare this with peers and in this way ascertain if their company is "fairly valued". However, it is fundamental that to understand and manage a firm's value, management must know the value of the firm and the factors that drive it. Each company should have a simple discounted cash flow model that is regularly updated and analysed by the finance department, and then is reported on a regular basis.

Once the company has a reliable financial model in place, management should conduct a sensitivity analysis to assess the impact on value generated by each item in the cash flow model. Identifying and understanding these items will help management determine value drivers, which should then be prioritised in terms of monitoring and improvement in order to understand and validate the company's share price.

2. Develop a corporate strategy designed to create shareholder value. Once the management is cognisant of the value of the firm and understands from what the value is derived, the next step is to consider ways in which they can enhance the firm's value. Beginning with developing a corporate strategy, management could hire a strategic or management consulting firm to help identify a value creation strategy or it could utilise a variety of management tools to develop strategy internally.

Regardless of the approach used to develop a strategy, it is vital that the new strategy is quantified and incorporated into the financial model in order to determine its impact on the company's value. This will help management anticipate the effect on its share price once the strategy is implemented and aid in making the decision whether or not to introduce this new strategy: i.e., is it essential to the improvement of the company's value or does it help create or conversely, actually harm the firm's value? In many cases, management unintentionally destroys value of a company when it implements a new strategy that does not complement its core competency and existing customer base.

3. Align the strategy with the firm's operations. A great strategy is a flop if it cannot be implemented. It is, therefore, critical that management takes time and makes the effort to translate the new strategy and properly align it at the different levels within the firm's operations. Firstly, the objectives and key performance indicators should be set for each business function based on this new strategy. Then all the projects, funding and resources should be allocated and prioritised accordingly in order to achieve the target. There are various tools, one of which is the "Balanced Scorecard", that can help align and translate the strategy to best mesh with company operations during implementation.

4. Link the value with management's performance and incentive compensation. To motivate management to create shareholder value, it is important to link management's performance and incentives to the firm's value and its drivers. A company's compensation scheme should attract, motivate and retain high-performing personnel. A good compensation scheme is easier said than done, but it should meet at a minimum three objectives:

✦ Align interest: give managers an incentive to choose strategies and investments that maximise shareholder value;

✦ Leverage commitment: use incentive to foster management commitments e.g. work long hours or take risks;

✦ Retention: give sufficient compensation during periods of poor performance arising out of factors that cannot be controlled.

5. Communicate your value to the investment community. Last but not least, to best manage value, management must communicate to the investment community on a regular basis and provide consistent information through all communication channels and to all targets. Many great companies with good performance sometimes are undervalued and under-covered because the financial community does not fully understand them and their strategies. Many also avoid giving out bad news by not communicating at all when things turn down. They fail to realise that the very act of shutting out the market tells the market they are doing poorly — and may in fact actually magnify the problems in the eyes of the market.

Thus, to grow value, management needs to ensure it has good investor relations and that it always sends out correct and honest messages to the financial community and that it maintains a high standard of corporate governance.

These five simple steps are probably not completely new ideas, as many, if not most manager, are already aware of some if not all of these simple steps that will aid them in creating and managing shareholder value. At the same time, even prestigious companies with good business performance are unable to execute all five steps because some do not understand their firm's value, some have not incorporated a value creation strategy, some fail to align their strategies with function KPIs, some do not have a compensation system that awards or penalises management with respect to the firm's value creation, and some do not sufficiently and consistently communicate their value creation and growth strategies to the financial community.

All of these oversights lead to a gap between a company's fair value and market value. If a company will then adopt these five simple steps, it will be able to embark on the road to creating, managing and sustaining its TSR for the long run.

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