

Manila Electric Company (MER)
BUY

A Brighter Tomorrow

Price	83.00
Target	112.70
Market Cap (Pb)	92,877
52 week High	105.45
52 week Low	23.64



Strong performance

For the third quarter of 2007, Meralco's income increased by 101% to P460 million compared to P226 million from a year ago. For January to September of this year, Meralco's income rose by 370% to P2.8 billion compared to last year's January to September income of P596 million. There was no provision for probable losses for this year. For the nine months that ended on September 2006, Meralco's provision for probable losses was P4.6 billion. Meralco's third quarter revenues were at P48.5 billion, up by 6.7%. Sales increased by 6%, the highest growth since 2000 with all three segments, Commercial, Residential, and Industrial, contributing to the growth. Total sales for the quarter were at 6,822 gWh and at 19,661 gWh for the year. Sales are expected to grow at 2% for 2008 and 2009 and at 4% for 2010 and 2011.

	2005	2006	2007	2008	2009
Revenues (PM)	174,268.00	190,787.00	246,327.79	395,340.90	516,984.25
Earnings (PM)	3,191.00	3,465.00	4,483.17	7,195.20	9,409.11
EPS	2.88	3.13	4.05	6.50	8.50
EPS Growth	-33.64%	8.68%	29.39%	60.49%	30.77%
P/E	4.49x	15.68x	20.50x	12.77x	9.76x
BV per share	31.96	43.15	46.28	50.33	56.83
P/BV per share	0.41x	1.14x	1.75x	1.65x	1.46x

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Improved Operations

Average rates peaked at P9.21 per kWh in July due to the resumption of the Automatic Generation Rate Adjustment (AGRA). The average rate dropped to P8.00 per kWh in September. This was due to a similar drop in generation costs. From P5.34 per kWh in July, the generation cost in September was at P4.54 per kWh. Furthermore, Purchased Power cost decreased due to lower generation costs from suppliers. System loss, mostly due to pilferage, has been steadily improving. Levels of System losses for the third quarter of 2007, YTD September 2007, and 12 month moving average (as of September 2007) all showed improvements of at least .45%. These improvements have been brought about by an intensified campaign against electricity pilferage. Meralco improved the quality of its service as evidenced by the lower IFR and CIT figures, which measure system reliability and availability respectively. Increased maintenance activities and a more favorable weather condition were the main factors for the improvement.

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Capital Expenditure for the first nine months of 2007 has reached P4.94 billion, up by 51.8% from last years nine month total. Capital Expenditures were primarily used for customer load growth, replacement of obsolete electrical facilities, and reduction of system loss.

Performance Based Rate

Starting next year, Meralco will switch from the 80 year old return on rate base (RORB) scheme to a Performance Based Rate (PBR) scheme. In the ERC's Final Determination, the ERC increased the maximum average distribution price that Meralco may set from P1.17 per kWh in 2008 to P1.37. The new maximum prices are P1.48 in 2009, P1.59 in 2010, and P1.71 in 2011.

Reconsiderations

However, not everything in the Final Determination of the ERC was to Meralco's favor. The ERC pegged Meralco's recoverable cost of capital at 12.80%. Meralco is looking at a WACC of 15.63%. According to Meralco, the ERC used a lower inflation rate and risk premium in determining the WACC of 12.80%. Meralco also appealed the non-allowance of any working capital for purchased power and the lack of additional allowance for pension funding expenses. Meralco also has pending application with the ERC for the recover of up to P22 billion in under recoveries since September 2006 to July 2007. In addition, Meralco has a petition against the Philippine Economic Zone Authority (PEZA), which claims to have authority to regulate operations of electric power within ecozones. On October 15, 2007, a 20-day TRO against the implementation of PEZA's guidelines was issued.

Recommendation

Year to date performance and operations bode well for Meralco. Sales are increasing and will continue to do so. Meralco continues to spend in order to provide better service to its customers, which is why the PBR scheme will be beneficial for Meralco. Continued improvement of System loss and system reliability and availability enhance the earnings of Meralco and the service provided to consumers. The maximum prices are higher than previously reported but are still lower than what Meralco asked for. Nevertheless, it is still an approved rate hike and the PBR scheme is an improvement over the old RORB scheme. Meralco's pending motion for reconsideration and application for recovery of past under recoveries and its petition against PEZA will have huge effects on their future pricing and earnings. If the decisions are in their favor then Meralco will be able to improve on this year's performance. However, the opposite is also true. An unfavorable resolution will curtail Meralco's ability to recover its expenses.

Meralco's executives are constantly in communication with the other parties in order to reach a resolution that is amicable to all. Meralco is confident that a favorable resolution will soon be reached. Even after reversing last year's provision for probable losses, this year and next year's earnings are expected to be higher. Using similar power distribution companies in the Asian region as comparables, we have come up with an average P/E of 17.34 times. Using our estimate of P6.50 for next years EPS, we have set a six month target price of P112.70. With an upside of 36%, MER is clearly a buy.

Company	2007 P/E	2008 P/E	2009 P/E
Shikoku Electric Power	24.30	22.66	22.01
Hokkaido Electric Power	15.13	17.94	17.31
Electric Power Development	21.49	19.45	19.03
Sarawak Energy	12.32	10.64	9.75
Hongkong Electric Holdings	11.94	11.49	14.42
Shanghai Electric	35.73	27.32	
CLP Holdings	11.38	11.87	14.12
Manila Electric Company	20.50	12.77	9.76