

BUY (update)

Refrigeration Electrical Engineering Corp. (HSX: REE)

Report date	May 23, 2019
Current price	VND 33,050
Target price	VND 38,200
Upside	16%
Bloomberg	REE VN
Market cap	VND 9,953bn USD 428mn
52 weeks movement	VND 28,100 – VND 35,300
Average daily value	VND 16bn USD 0.7mn
FOL	49%
Current FO	49%

Awaiting more M&A and investment deals

Our takeaway

- REE intends to conduct an M&A deal with a 35MW hydro power plant (annual planned profit of VND 40bn) and to invest in a 48MW wind power plant in Tra Vinh province for Phase 1 (groundbreaking in Oct 2019). Further information regarding capex, investment time and value, and holding structure are not disclosed yet.
- Although we estimate the newly announced Etown 6 project will contribute an annual net profit of VND 380bn (on average, occupancy rate of 98% from 2024), cash flow improvement from the project will be offset by investment outlay in 2021-2022 and principal repayment of VND 2,318bn in 2029, as interest expense will not be capitalized.

What's new

M&A and investment deals as a growth driver. Currently, REE intends to conduct an M&A deal with a 35MW hydropower plant, which is expected to contribute VND 40bn per annum to REE's profit from 2020. Besides, REE will invest in a wind power plant in Tra Vinh province with a total capacity of 100MW. We expect that Phase 1 of the wind power project of 48MW will start operating by Nov 2021 to enjoy tariff of 9.8 US cents/kWh for offshore projects and contribute VND 38bn, or 2% of REE's net profit annually from 2022 (long-term loan repayment period) and the IRR would be 11%.

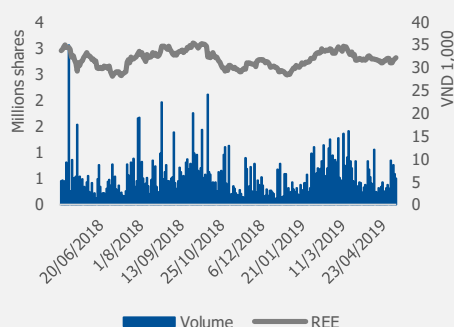
Expected flat net profit for FY19 and FY20. Due to unsound outcomes of power segment, we forecast REE's bottom line in FY19 of VND 1,762bn (-1% yoy and 20% higher than FY19 plan). For FY20, we expect net profit at VND 1,889bn (+7%yoy). Earnings growth drivers come from new projects including the Etown 5 office for lease, the Cu Jut solar power project of Central Hydropower JSC (HOSE: CHP). The Thuong Kon Tum hydropower project (TKT) of Vinh Son Song Hinh Hydroelectric Power JSC (HOSE: VSH) is expected to start operating in 2020, albeit at a loss of VND 85bn, before gaining a net profit of VND 350bn per annum for the ten succeeding years.

Risk of selling price (Pc) decrease after PPA (power purchase agreement) is renegotiated with EVN (Vietnam Electricity Group) in 2019. If Pc decreases by 10% at 3 associates and an investment entity of REE, net profit from FY20 onwards will reduce by 2% and dividend received will decrease by VND 32bn on average.

Valuation

We maintain our 12-month target price of VND 38,200 (16% upside) and upgrade our recommendation from HOLD to BUY. The stock is currently trading at FY19F P/E of 6x, which is lower than its five-year historical P/E of 7x. We note that upside potential of our target price comes from positive news of the forthcoming M&A and investment deals whereas flat profit for FY19 and FY20 and negative results of TKT implies downside risk for the stock.

Price movement



Stock performance	1M	3M	12M
REE (%)	1%	0%	-5%
VNIndex (%)	-3%	+5%	-7%

Source: Bloomberg

Major Shareholders

State-owned (HFIC)	5.3%
Nguyen Thi Mai Thanh	7.3%
Nguyen Ngoc Hai	5.5%
Platinum Victory Pte Ltd.	24.9%
Apollo Asia Fund Ltd.	5.9%



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Unit: VND billion	FY18	FY19F	FY20F	FY21F
Revenue	5,101	5,699	5,921	5,716
EBIT	2,345	2,425	2,531	2,775
Net profit	1,784	1,762	1,889	2,136
Net profit (basic)	1,686	1,811	1,889	2,136
EPS (VND)	5,754	5,675	6,049	6,847
EPS growth rate (%)	30%	-1%	7%	13%
P/E (x)	6	6	5	5
EV/EBITDA (x)	6	6	5	5
DPS (VND)	1,800	1,600	1,600	1,600
Dividend yield (%)	5%	5%	5%	5%
P/B (x)	1.0	0.9	0.8	0.7
ROE (%)	19%	17%	16%	16%
Net debt/equity (%)	37%	44%	31%	24%

Source: MBS Research

M&A and investment deals as a growth driver

REE intends to conduct an M&A deal with a 35MW hydropower plant. The incremental profit for REE is projected at VND 40bn per annum, or 2% of its net profit. In particular, REE will hold 40% stake and Thac Ba Hydroelectric JSC (HOSE: TBC), a subsidiary of REE, will hold the rest.

REE also considers investing in a wind power plant in Tra Vinh province with a total capacity of 100MW. Phase 1 with capacity of 48MW is expected to start operating in Nov 2021 to enjoy tariff of 9.8 US cents/kWh for offshore projects, according to the Decision No 39/2018/QĐ-TTg dated 10/9/2018.

Further information regarding capex, investment time and value, and holding structure is not disclosed yet. We expect the 48MW wind power project will earn a net profit of VND 38bn per year, or 2% of REE's net profit, in its first 10 years (long-term loan repayment period) and the IRR will be about 11%.

1Q19 net profit declined by 8% yoy to VND 352bn

1Q19 net profit declined by 8% yoy mainly due to bad performance of the largest earnings contributor: the power segment. Net profit of this segment decreased by 29% yoy due to unfavorable hydrologic conditions, including:

- TBC (net profit: VND 45bn, -43% yoy),
- Thac Mo Hydroelectric JSC (HOSE: TMP) (VND 47bn, -29% yoy),
- Song Ba Hydroelectric Power JSC (Upcom: SBH) (VND 50bn, -32% yoy),
- Vinh Son Song Hinh Hydroelectric Power JSC (HOSE: VSH) (VND 76bn, -51% yoy)...

The profit decline of power segment was enlarged by provisions for Quang Ninh Thermal Power JSC (Upcom: QTP) investment: VND 62bn and VND 124bn provisions were made in 1Q19 by REE and its associate Pha Lai Thermal Power JSC (HOSE: PPC), respectively. Instead, in 1Q18 REE had a VND 66bn reversal of provision for investment.

In contrast, other companies in the group had positive results, albeit insufficient. For instance, CHP, a hydropower company, gained a net profit of VND 60bn in 1Q19, bounced back from a loss of VND 74bn in 1Q18 due to major inspection. PPC, a coal-fired thermal power plants, also recorded 1Q19 net profit of VND 243bn (+27% yoy) thanks to VND 106bn one-off revenue and EBT (i.e., zero COGS due to PPA mechanism) from reimbursement from EVN for foreign exchange losses. REE's 1Q19 net profit is equivalent to 20% of our full-year forecast. The real estate segment is expected to record in the 2nd half of the year.

Expected flat net profit of VND 1,410bn for the last 9M19

Similar to 1Q19, we expect that office leasing segment would continue offsetting unsound outcomes of power segment. We do not assume any provision or reversal for investment in the last 9M19, unlike the reversal of provision for investment of VND 57bn and VND 179bn in the last 9M18 of REE and PPC, respectively. For FY19, we forecast REE's bottom line of VND 1,762bn, nearly unchanged yoy (-1%) and 20% higher than FY19 plan.

New projects pushing net profit up 7% yoy in FY20 and 13% yoy in FY21

The positive outlook for REE comes from operation of (i) the Etown 5 office for lease project (lease office area of 17,000 m², expected annual net profit of VND 62bn, 3% of total), and (ii) promising earnings growth of REE's associates thanks to new projects of CHP and VSH.

VSH: We forecast the Thuong Kontum hydropower project (220 MW, 62% larger than current VSH's total capacity) will start operating from 2020. In the first year of operation, it could incur a loss of VND 85bn due to a low temporary P_c of about 800 VND/kWh, which is estimated ex ante from the initial approved investment of VND 5,744bn and applied during the finalization phase of work construction, normally 10 months.

After that, PPA will be adjusted upward based on the actual incurring cost (65% higher), according to REE. With the official PPA agreement, it could bring an annual net profit of about VND 350bn for VSH in the period of 2021-2030, approximating net profit of the existing hydropower plants Vinh Son and Song Dinh. However, even with significant profit, the operating cash flow of this project is expected to be just enough to repay long term loans. Therefore, we believe there would be no increase in dividends paid by VSH during the aforesaid period. The IRR of the project would be about 9%, based on:

- **Average Pc in PPA is anticipated at 1,200 VND/kWh** to cover huge capex of VND 9,500bn. We believe this selling price is acceptable because Thuong Kontum project is one of the few remaining large hydropower projects with low selling price compared to thermal power projects, though it is still 67% higher than that of existing hydropower plants. We estimate that in the period of 2020-2030 the project would "run in profile" with 30% higher electricity selling price than the average Pc in order to meet debt service obligations.
- **Average volume would be around 950 million kWh per annum** with utilization of 49%, lower than 63% of current VSH's plants, as the project is subject to the Decision No. 215/QĐ-TTg effective on February 13, 2018 regarding Issuance of the inter-reservoir operating procedures in Se San River.
- **Projected depreciation period of 35 years** is longer than regulatory depreciation period of 20-25 years according to Circular 45/2013/TT-BT (A Guide To Management Mode, Use And Depreciation Of Fixed Assets). We expect the company would propose to extend depreciation period to match the useful lives of hydropower plant, as it did with other existing plants (38-40 years), and to ease annual depreciation costs.

There is a litigation risk of compensating the Hoa Dong Chinese contractor VND 2,163bn within 15 days from decided date on April 10, 2019, arbitrated by Vietnam International Arbitration Centre (VIAC). On May 2, 2019, VSH submitted a dossier to the Vietnamese court to appeal the decision of the arbitration tribunal. In the worst case, we believe VSH would face liquidity risk due to the compensation as its liability/total asset ratio could increase from 62% to 89% and current ratio could decrease from 1.43 to 0.24.

In 2019, PGV (GENCO 3) plans to divest its holdings of 30.55% in VSH, and REE has shown its interest in this deal. In case of successfully acquiring this divested stake, REE would turn its associate VSH into a subsidiary.

CHP: The operation of Cu Jut solar power project (50 MWac) starting from May 2019 could enjoy tariff of 9.35 US cents/kWh. It is assumed to generate about 95 million kWh annually and net profit of VND70bn in the first twelve years (long-term loan repayment period), resulting in IRR of 14%.

Table 1: Key assumptions of power projects

	Thuong Kon Tum hydro power	Cu Jut solar power
Capacity	220 MW	50 Mwac
Starting operation	2020	May 2019
Capex (VND bn)	9,500	1,367
Depreciation period (years)	35	20
Financed by loans	74%	62%
Interest rate	10%	8%
Loans maturity	2030	2031
Pc	1,200 VND/kWh	9.35 US cents/kWh
Selling volume (million kWh)	950	95
Utilization	49%	
Degradation rate		0.7%
IRR	9%	14%

Source: VSH, CHP, MBS Research

Risk of Pc decrease after PPA is renegotiated with EVN

This could negatively affect the associates and other investment entities of REE from FY20 onwards, including Song Ba Hydroelectric Power (SBH), Central Hydropower (CHP), Pha Lai Thermal Power (PPC, for the Pha Lai 1 coal-fired thermal power plant), Quang Ninh Thermal Power (QTP). If Pc decreases by 10% at these companies, net profit of REE from FY20 onwards will reduce by 2% and dividend received will decrease by VND 32bn on average.

Financials and Valuation Summary

Income statement (VND bn)	FY18	FY19F	FY20F	FY21F
Net revenue	5,101	5,699	5,921	5,716
Cost of goods sold	3,873	4,031	4,138	3,903
Gross profit	1,228	1,668	1,783	1,813
Financial income	304	289	201	201
Financial expenses	111	350	331	295
Profit of associates	999	886	931	1,167
Selling expenses	99	114	118	114
G&A expenses	215	237	260	286
Operating profit	2,106	2,143	2,204	2,485
Other profit	12	4	4	4
EBT	2,118	2,147	2,208	2,489
EAT	1,884	1,910	1,965	2,215
Net profit	1,784	1,762	1,889	2,136
Minority interests	100	149	77	79

Balance sheet (VND bn)	FY18	FY19F	FY20F	FY21F
Current assets	6,357	9,027	9,883	9,563
I. Cash & cash equivalents	1,865	3,325	4,030	3,914
II. Short-term investments	1,139	1,139	1,139	1,139
III. Current accounts receivable	2,335	2,591	2,691	2,598
IV. Inventories	969	1,920	1,971	1,859
V. Other current assets	49	53	53	53
Non-current assets	9,772	10,303	10,485	11,878
I. Long-term receivables	34	34	34	34
II. Fixed assets	445	397	347	296
1. Tangible fixed assets	415	368	320	271
2. Intangible fixed assets	30	29	27	25
III. Investment properties	1,602	1,997	1,860	1,724
IV. Long-term assets in progress	153	0	0	1,000
V. Long-term investments	6,992	7,330	7,698	8,278
VI. Other long-term assets	546	546	546	546
Total assets	16,129	19,330	20,368	21,441
Liabilities	5,571	8,201	7,862	7,310
I. Current liabilities	3,056	3,870	4,028	3,884
1. Short-term payables	1,945	2,914	3,063	3,024
2. Short-term loans	1,111	956	965	860
II. Non-current liabilities	2,515	4,331	3,834	3,426
1. Long-term payables	445	445	445	445
2. Long-term loans	2,070	3,886	3,389	2,981
Equity	10,558	11,129	12,506	14,131
1. Charter capital	3,101	3,101	3,101	3,101
2. Surplus	1,050	1,050	1,050	1,050
3. Retained earnings	5,797	6,368	7,745	9,370
4. Minorities interests	610	610	610	610
Total liabilities & equity	16,129	19,330	20,368	21,441

Key ratios	FY18	FY19F	FY20F	FY21F
Valuation				
EPS (VND)	5,754	5,675	6,049	6,847
BVPS (VND)	32,018	35,887	40,330	45,570
P/E	6	6	5	5
P/B	1.0	0.9	0.8	0.7
Profitability				
Gross profit margin	24%	29%	30%	32%
EBITDA margin	49%	46%	46%	52%
Net profit margin	35%	31%	32%	37%
ROE	19%	17%	16%	16%
ROA	12.0%	10.1%	9.5%	10.2%
Growth				
Revenue growth	2%	12%	4%	-3%
EBITDA growth	30%	5%	5%	9%
EBT growth	23%	1%	3%	13%
Net profit growth	30%	-1%	7%	13%
EPS	30%	-1%	7%	13%
Total assets	8%	25%	5%	5%
Equity	14%	12%	12%	13%
Liquidity				
Current ratio	2.08	2.33	2.45	2.46
Quick ratio	1.76	1.84	1.96	1.98
Liabilities/Total assets	36%	42%	39%	34%
Liabilities/Equity	0.56	0.74	0.63	0.52
Interest coverage ratio	10.58	8.70	7.85	9.69
Operating efficiency				
Receivables turnover	3	2	2	2
Days sales outstanding	124	166	166	166
Inventory turnover	3	2	2	2
Days sales of Inventory	119	174	174	174
Payables turnover	2	2	2	2
Days payables outstanding	198	203	203	203

Cashflow Statement (VND bn)				
CFO	91	83	952	1,133
CFI	(219)	273	737	(239)
CFF	(403)	1,103	(984)	(1,010)
Net cash flows during the period	(531)	1,460	705	(115)

Source: MBS Research

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STOCK RATING: The recommendation is based on the difference between the 12-month target price and the current price:

Rating	When (target price – current price)/ current price
BUY	>=15%
HOLD	From -15% to +15%
SELL	<= -15%

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