A Tale of Two State-Owned Enterprises

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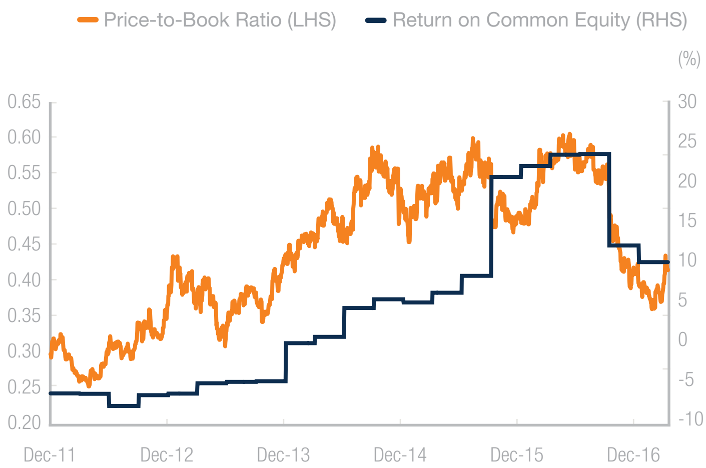
April 2017

It's always fascinating to observe how the stocks of companies in the same sector, either in the same country or across different countries, can trade so differently from one another. What influences these intangible metrics called valuation multiples, such as "price-to-book (P/B)" or "price-earnings (P/E)?" Do they remain static or do they change over time?

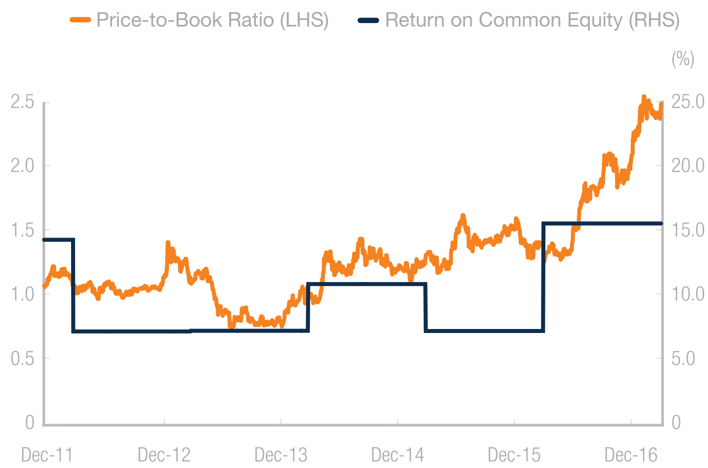
A simple story to illustrate the above would be to look at the history of two state-owned enterprises (SOEs): Korea Electric Power Corporation (KEPCO), Korea's leading power utility provider with group capacity in excess of 75,000 megawatts (MW); and Indian Oil Corporation (Indian Oil), India's leading refiner and fuel retailer possessing over 80 million tons per annum (mtpa) of refining capacity that holds a dominant fuel retailing market share in India.[1] KEPCO and Indian Oil shared a similar story until three years ago as both companies were loss-making SOEs trading at significant discounts relative to their respective local markets and regional peers.

KEPCO



Source: Bloomberg, Mirae Asset Global Investments (2017)

Indian Oil Corporation



Source: Bloomberg, Mirae Asset Global Investments (2017)

[1] Company disclosures, Mirae Asset Global Investments (2017)

A Rosier Outlook

Things began to look very different for both companies around 2014 and 2015. KEPCO increased its share of nuclear power generation, raised tariffs, and eventually turned profitable while Indian Oil benefited from a pragmatic Modi government that allowed the firm to completely pass on the fuel cost increases of their main products, diesel and gasoline.

Both companies produced handsome returns and outperformed their local respective markets. Indian Oil's story is somewhat more interesting in terms of demonstrating how a good and efficient government can create a win-win situation for all stakeholders. Building on the previous government's policy from 2013 of permitting oil marketing companies to implement a marginal monthly price increase, an action that was adopted during the US Federal Reserve's tapering crises, the Modi government went a step further towards reducing subsidies on other products like LPG (liquefied petroleum gas) and kerosene. Despite this policy receiving a lot of criticism on how the poor in India would be negatively impacted by fuel price hikes, the Modi Government persevered with what was right.

Different Contexts, Similar Outcomes

Indian Oil's performance turnaround was achieved by ensuring marginal monthly price increases and, more importantly, specifically targeting commercial establishments that were not entitled to subsidized fuel through direct benefit transfer to the middle and low income households. The Indian government's interference in price setting for the sector has reduced considerably since 2014. Consequently, the return on equity (ROE) for Indian Oil has improved from 8% in 2013 to 15% and it is expected to increase to 20% in the next 2 years, while the P/B ratio has re-rated from 0.6 to 2.4, resulting in approximately 400% return for shareholders since 2013.[2] Having been restored to profitability, Indian Oil is spending nearly USD 4-5 billion annually to upgrade and build new refineries, boosting employment and local governments.[3] Moreover, the value of the Indian government's majority stake in Indian Oil has gone up fourfold to nearly USD 17 billion.

In contrast, although KEPCO's stock is up 50% from its lows in 2013 as the company has returned to the black, the absence of a fair tariff-setting mechanism and fears of government intervention have constrained its re-rating. KEPCO trades at a large discount to regional peers, so it is not hard to imagine the potential gains for the Korean government and people at large should this discount narrow with a more predictable and fair tariff-setting mechanism. Similar to India, where healthy state-owned oil marketing companies are at the forefront of capital expenditures, KEPCO can set a global precedent for safe, low-cost nuclear energy from Korea. A win of USD 20 billion of nuclear orders from the United Arab Emirates was clearly positive for KEPCO, yet the journey to achieve credibility as global nuclear utility is long and arduous.[4]

Awaking the SOE Giants

Our tale of two SOEs highlights that putting short term-noise aside, markets are smart in the medium term at valuing businesses and owners on their ability to generate healthy returns and provide a fair outcome to all stakeholders. For SOEs and their majority shareholders – the government – the road to populism is always tempting in the short-term though good, strong leadership is all about combining doing the right thing with pragmatism. If the sleeping state-owned giants can get their act together, the potential rewards are immense!

Price Discovery: Rewarding SOE Businesses

Source: Bloomberg, Mirae Asset Global Investments (2017)

[2] Bloomberg, Mirae Asset Global Investments (2017)
[3] Company Disclosures, Mirae Asset Global Investments (2017)
[4] Company Disclosures, Media Reports, Mirae Asset Global Investments (2017)

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