

Contact Energy

NEUTRAL

Sluggish Start to FY20 — 1Q20 Operating Statistics

It has not been a great start to FY20 for Contact Energy (CEN), with below average hydro generation lifting the average cost of generation. We estimate 1Q20 EBITDAF was \$113m, -\$23m lower than the pcg (on a continuing operation basis). We have cut our FY20 EBITDAF forecast -\$21m to \$467m.

What's changed?

- **Earnings:** FY20 EBITDAF cut -\$21m to \$467m
- **Target Price:** Unchanged at \$8.22
- **Rating:** NEUTRAL rating retained

Lack of hydro hurting earnings

1Q20 hydro generation totalled 820GWh, -7% lower than the pcg, with September hydro generation particularly weak, -28% down on the pcg and -40% below average. Thermal generation was up +9% meaning the cost of generation was +\$26m more than 1Q19 (although part of the cost increase relates to CEN Ahuroa gas storage facility lease costs).

We calculate that 1Q20 EBITDAF was \$113m, -\$23m lower than the pcg on a continuing earnings basis (-\$35m lower including 1Q19 LPG earnings).

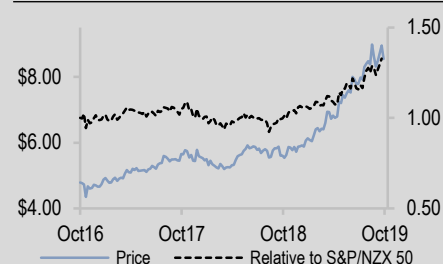
Forecast changes reflect poor start to FY20 and weak hydro storage

The poor start to FY20 and hydro storage well below average (EnergyLink is reporting CEN's current hydro storage at 143GWh, -36% below average following a positive week) has led to our -\$21m FY20 EBITDAF cut to \$467m. We also note that October/November 2018 were CEN's best months in FY19 (by a considerable margin), so CEN's FY20 performance vs. pcg is going to get worse in the short-term.

We have only made minor changes to our long-term forecasts; hence, there is no change to our \$8.22 target price.

NZX Code	CEN
Share price	NZ\$8.55
Target price	NZ\$8.22
Risk rating	Low
Issued shares	715.5m
Market cap	NZ\$6,118m
Average daily turnover	1,192k (NZ\$8,221k)

Share Price Performance



Financials: June	19A	20E	21E	22E
NPAT* (NZ\$m)	280.4	249.0	264.9	272.5
EPS* (NZc)	39.2	34.8	37.0	38.1
EPS growth* (%)	23.4	-11.2	6.4	2.8
DPS (NZc)	39.0	39.0	39.5	40.0
Imputation (%)	64	60	70	75

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	14.1	15.1	14.4	14.1
EV/EBIT	23.3	26.7	24.4	23.3
PE	21.8	24.6	23.1	22.5
Price / NTA	2.6	2.7	2.9	n/a
Cash dividend yield (%)	4.6	4.6	4.6	4.7
Gross dividend yield (%)	5.7	5.6	5.9	6.0

*Historic and forecast numbers based on underlying profits

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Investment View

Our rating is NEUTRAL. We view CEN as fairly valued. It offers a high degree of earnings and therefore dividend certainty but more limited growth. Whilst the current interest rate environment is supportive of elevated share prices, a lift in interest rates poses downside risk.

Contact Energy Limited (CEN)

Priced as at 17 Oct 2019: NZ\$8.55

June year end

Forsyth Barr valuation					Valuation Ratios		2018A	2019A	2020E	2021E	2022E
Valuation methodology		Blend of spot valuations, weighted to multiples			EV/EBITDA (x)		15.9	14.1	15.1	14.4	14.1
					EV/EBIT (x)		29.4	23.3	26.7	24.4	23.3
12-month target price (NZ\$)*		8.22	Spot valuations (NZ\$)		PE (x)		26.9	21.8	24.6	23.1	22.5
Expected share price return		-3.9%	1. DCF	7.50	Price/NTA (x)		2.7	2.6	2.7	2.9	3.0
Net dividend yield		4.6%	2. Market multiples	8.28	Free cash flow yield (%)		4.9	5.5	4.1	4.8	4.9
Estimated 12-month return		0.7%	3. Dividend yield	9.01	Net dividend yield (%)		3.7	4.6	4.6	4.6	4.7
					Gross dividend yield (%)		4.4	5.7	5.6	5.9	6.0
Key WACC assumptions			DCF valuation summary (NZ\$m)		Imputation (%)		48	64	60	70	75
Risk free rate		2.00%	Total firm value	6,474	Pay-out ratio (%)		101	100	112	107	105
Equity beta		0.88	(Net debt)/cash	(1,108)							
WACC		6.6%	Value of equity	5,366	Capital Structure		2018A	2019A	2020E	2021E	2022E
Terminal growth		1.5%	Shares (m)	716	Interest cover EBIT (x)		3.3	4.8	5.0	5.4	5.7
					Interest cover EBITDA (x)		5.7	7.4	8.0	8.4	8.7
Profit and Loss Account (NZ\$m)		2018A	2019A	2020E	2021E	2022E	Net debt/ND+E (%)		34.7	25.3	26.8
Sales revenue		2,275	2,519	2,371	2,292	2,272	Net debt/EBITDA (x)		3.0	1.8	2.1
Normalised EBITDA		479	518	467	491	502					
Depreciation and amortisation		(220)	(205)	(202)	(201)	(199)	Key Ratios		2018A	2019A	2020E
Normalised EBIT		259	313	265	290	303	Return on assets (%)		4.9	9.8	5.5
Net interest		(84)	(70)	(58)	(58)	(58)	Return on equity (%)		4.7	6.3	5.6
Depreciation capex adjustment		99	104	100	98	96	Return on funds employed (%)		4.5	9.4	5.3
Tax		(48)	(72)	(58)	(65)	(69)	EBITDA margin (%)		21.1	20.6	19.7
Minority interests		-	-	-	-	-	EBIT margin (%)		11.4	12.4	11.2
Adjusted normalised NPAT		227	280	249	265	272	Capex to sales (%)		3.6	2.5	3.9
Abnormals/other		(97)	65	(100)	(98)	(96)	Capex to depreciation (%)		37	31	46
Reported NPAT		130	345	149	167	177					
Normalised EPS (cps)		31.7	39.2	34.8	37.0	38.1	Operating Performance		2018A	2019A	2020E
DPS (cps)		32.0	39.0	39.0	39.5	40.0	Divisional Revenue (\$m)		2021E	2022E	
							Wholesale electricity		1,157	1,463	1,344
Growth Rates		2018A	2019A	2020E	2021E	2022E	Retail electricity		883	863	873
Revenue (%)		9.4	10.7	-5.9	-3.3	-0.9	Retail gas sales		71	73	81
EBITDA (%)		-4.4	8.1	-9.9	5.3	2.3	LPG sales		121	58	-
EBIT (%)		-11.6	20.8	-15.4	9.7	4.4	Other		31	32	33
Normalised NPAT (%)		9.1	23.4	-11.2	6.4	2.8	Total Revenue		2,263	2,489	2,331
Normalised EPS (%)		9.1	23.4	-11.2	6.4	2.8			2,489	2,331	2,240
DPS (%)		23.1	21.9	0.0	1.3	1.3			2,240	2,210	
							Operating Statistics				
Cash Flow (NZ\$m)		2018A	2019A	2020E	2021E	2022E	Hydro generation (GWh)		3,479	4,232	3,722
EBITDA		479	518	467	491	502	Geothermal generation (GWh)		3,323	3,257	3,346
Working capital change		38	(19)	(6)	(7)	(1)	Thermal generation (GWh)		1,812	1,422	1,694
Interest & tax paid		(111)	(112)	(118)	(128)	(134)	Total Generation (GWh)		8,614	8,911	8,763
Other		(27)	14	-	-	-	GWAP (\$/MWh)		85	129	122
Operating cash flow		379	401	343	357	368	Gas consumed (PJ)		17.5	13.9	16.1
Capital expenditure		(82)	(63)	(93)	(65)	(66)	Gas price (\$/GJ)		6.1	7.1	7.2
(Acquisitions)/divestments		6	382	-	-	-	Retail electricity volumes (GWh)		6,997	6,554	6,108
Other		(7)	-	-	-	-	Electricity customers (000)		413	411	411
Funding available/(required)		296	720	250	292	301	Average usage/customer (MWh)		8.7	8.6	8.6
Dividends paid		(201)	(251)	(279)	(279)	(283)	Average retail price (\$/MWh)		242	244	247
Equity raised/(returned)		1	-	-	-	-					
Increase/(decrease) in net debt		(96)	(469)	29	(13)	(19)					
							Balance Sheet (NZ\$m)				
Balance Sheet (NZ\$m)		2018A	2019A	2020E	2021E	2022E	LWAP (\$/MWh)		91	138	133
Working capital		(22)	(3)	3	10	11	LWAP/GWAP		1.07	1.07	1.09
Fixed assets		4,253	4,126	4,017	3,881	3,748	Retail gas volumes (PJ)		2.9	3.1	3.2
Intangibles		441	425	425	425	425	Gas customers (000)		65	67	67
Other assets		404	132	132	132	132	Average gas sales price (\$/GJ)		24.6	23.6	25.5
Total funds employed		5,076	4,680	4,577	4,448	4,316					
Net debt/(cash)		1,448	943	972	960	941					
Other non current liabilities		901	955	950	941	931					
Shareholder's funds		2,727	2,782	2,655	2,547	2,444					
Minority interests		-	-	-	-	-					
Total funding sources		5,076	4,680	4,577	4,448	4,316					

* Forsyth Barr target prices reflect valuation rolled forward at cost of equity less the next 12-months dividend

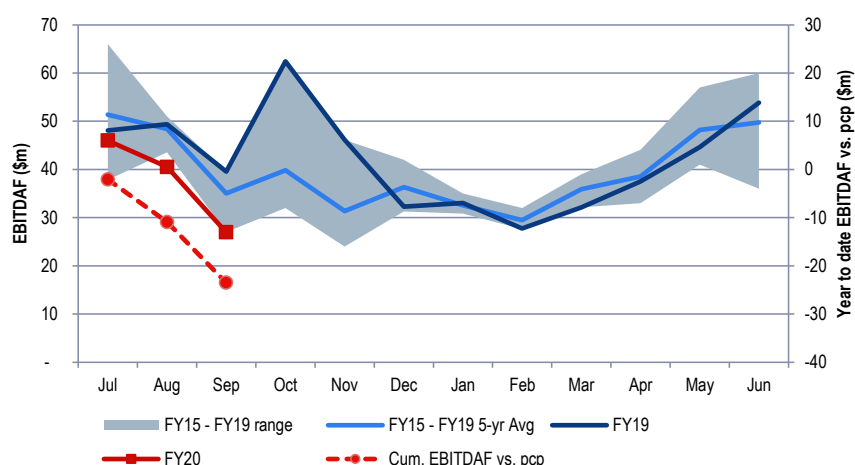
September 2019 / 1Q20 operating performance

Figure 1. EBITDAF breakdown

Summary	Sep-18 \$m	Sep-19 \$m	Difference		Year to date			
					FY19 \$m	FY20 \$m	Difference	
			\$m	%			\$m	%
Trading performance	3.3	3.0	(0.3)	-8%	5	12	7	129%
Cost of generation	(28.2)	(37.9)	(9.7)	34%	(81)	(107)	(25)	31%
Contracted wholesale sales	57.1	58.0	0.9	2%	200	206	5	3%
Wholesale	32.2	23.2	(9.0)	-28%	124	111	(13)	-11%
Retail	9.5	5.6	(3.9)	-41%	19	8	(11)	-57%
Corporate costs (estimated)	(2.2)	(1.8)	0.3	-15%	(7)	(6)	1	-15%
Continuing operation EBITDAF	39.5	26.9	(12.6)	-32%	137	113	(23)	-17%
LPG	3.3	0.0	(3.3)	-100%	12	0	(12)	-100%
Estimated EBITDAF	42.9	26.9	(15.9)	-37%	149	113	(35)	-24%

Source: CEN, Forsyth Barr analysis

Figure 2. Monthly EBITDAF performance



Source: CEN, Forsyth Barr analysis

Summary forecast changes

Figure 3. Forecast changes

	FY20			FY21			FY22		
	Old	New	% chg	Old	New	% chg	Old	New	% chg
Revenue	2,413	2,371	-1.8%	2,332	2,292	-1.7%	2,341	2,272	-3.0%
EBITDAF	488	467	-4.4%	491	491	0.2%	501	502	0.3%
EBIT	286	265	-7.5%	290	290	0.3%	302	303	0.4%
Reported NPAT	165	149	-9.7%	167	167	0.1%	177	177	0.1%
Adjusted NPAT	265	249	-6.1%	265	265	0.1%	272	272	0.1%
EPS	37.0	34.8	-6.1%	37.0	37.0	0.0%	38.0	38.1	0.1%
DPS	39.0	39.0	0.0%	39.5	39.5	0.0%	40.0	40.0	0.0%
Generation (GWh)	8,857	8,763	-1.1%	8,937	8,937	0.0%	9,018	9,018	0.0%
Electricity Wholesale Price (\$/MWh)	\$114.4	\$122.2	6.8%	\$95.7	\$100.2	4.7%	\$91.9	\$93.0	1.2%
Retail Demand (GWh)	6,548	6,108	-6.7%	6,692	6,234	-6.8%	6,678	6,229	-6.7%

Source: Forsyth Barr analysis

Investment summary

Our rating is **NEUTRAL**. We view CEN as fairly valued. It offers a high degree of earnings and therefore dividend certainty but more limited growth. Whilst the current interest rate environment is supportive of elevated share prices, a lift in interest rates poses downside risk.

Key drivers

- **Wholesale electricity prices and the electricity demand/supply balance:** The wholesale electricity price is the key driver of retail and commercial prices and therefore the key value driver. The electricity demand/supply balance and the cost of new generation underpin the wholesale price. Currently the NZ market is balanced.
- **Retail margins:** In recent years intense retail competition and new entrant retailers have eroded retail margins. Strong margins support profitability.
- **Hydrology:** Short-term earnings are impacted by hydrology. CEN prefers wet conditions as it lowers its average cost of generation. However, CEN's thermal fleet provides it with some downside protection from dry conditions.

Other key company and industry issues

- **Increased carbon costs:** Following changes to the Emissions Trading Scheme, CEN has to relinquish more carbon credits and carbon prices have increased materially. This is a modest headwind for FY20.

Upcoming catalysts/events

- **Transmission pricing review:** The TPM review will create industry winners and losers, with CEN likely to be a moderate winner. The Electricity Authority is aiming to finalise its decision in 2020, although the Electricity Price Review has added uncertainty.
- **Geothermal development:** CEN has one of the best generation development opportunities in its Tauhara geothermal field. With modest electricity demand growth expected and CEN likely to close its base-load gas plant within three years, there is a strong chance it develops this field.
- **Success of cost-out:** CEN has successfully removed operating and capital costs over the past four years. It believes additional cost-out opportunities exist; delivering on these will be important for earnings.

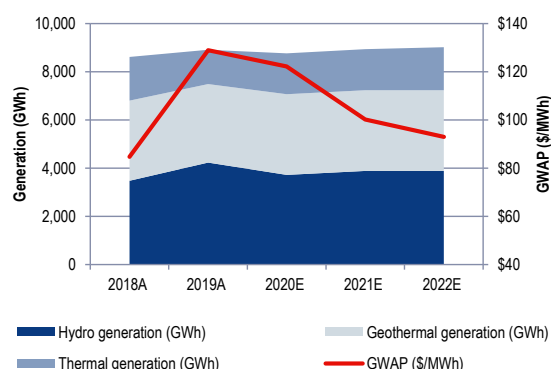
Key risks

- **Political/regulatory:** The 2014 election highlighted the political/regulatory risks inherent in the sector. Whilst the Electricity Price Review creates some uncertainty, we believe there is as much upside as downside risk, and in any case is unlikely to have a material impact on CEN.

Company description

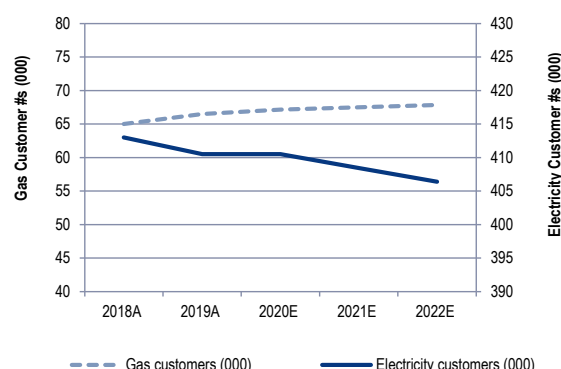
CEN generates around 25% of New Zealand's electricity and supplies electricity, gas and LPG to ~560,000 customers nationwide. Its generation portfolio consists of gas (a combined-cycle gas turbine and a gas-peaking plant), hydro (on the Clutha River in the South Island) and geothermal (in the central North Island). CEN typically produces ~8,800 GWh of electricity per annum and sells ~7,800 GWh of electricity, around half of which is sold to mass market customers. CEN produces strong cash flows which it intends to return to shareholders.

Figure 4. Generation volumes and average generation price



Source: CEN, Forsyth Barr analysis

Figure 5. Customer numbers



Source: CEN, Forsyth Barr analysis

Figure 6. Substantial Shareholders

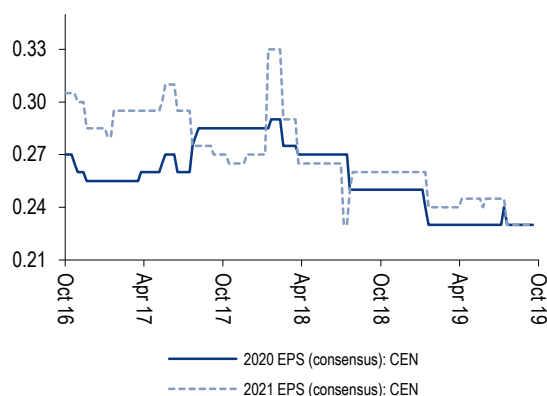
Shareholder	Latest Holding
No current substantial shareholders	

Figure 7. International Compcos

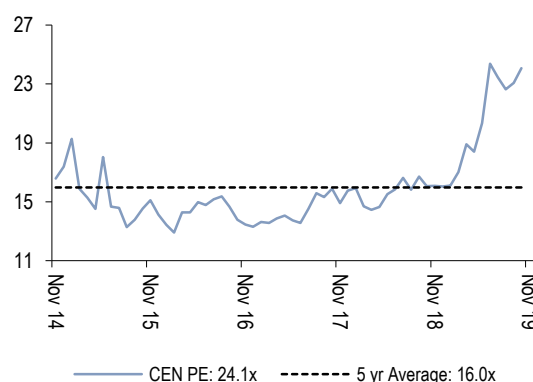
Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash D/Yld
<i>(metrics re-weighted to reflect CEN's balance date - June)</i>				2020E	2021E	2020E	2021E	2020E	2021E	2021E
Contact Energy	CEN NZ	NZ\$8.55	NZ\$6,118	24.6x	23.1x	15.1x	14.4x	26.7x	24.3x	4.6%
Genesis Energy *	GNE NZ	NZ\$3.39	NZ\$3,470	22.1x	17.8x	12.7x	11.5x	29.8x	24.2x	5.2%
Meridian Energy *	MEL NZ	NZ\$5.34	NZ\$13,674	30.9x	31.4x	19.6x	19.7x	32.8x	32.5x	4.0%
Mercury *	MCY NZ	NZ\$5.50	NZ\$7,493	32.8x	27.6x	17.6x	16.4x	29.9x	27.1x	2.9%
Trustpower *	TPW NZ	NZ\$8.21	NZ\$2,570	24.4x	23.9x	14.9x	14.5x	18.7x	18.2x	4.3%
AGL Energy	AGL AT	A\$19.45	A\$12,709	15.1x	15.1x	7.3x	7.3x	11.2x	11.4x	5.0%
ERM Power	EPW AT	A\$2.40	A\$601	12.0x	16.1x	7.1x	6.7x	10.1x	9.5x	4.2%
Origin Energy	ORG AT	A\$8.12	A\$14,301	13.8x	13.0x	6.3x	6.2x	15.1x	14.7x	4.5%
Compcos Average:				21.6x	20.7x	12.2x	11.8x	21.1x	19.7x	4.3%
CEN Relative:				+14%	+12%	+24%	+22%	+26%	+24%	+7%

EV = Current Market Cap + Actual Net Debt

Source: *Forsyth Barr analysis, Bloomberg Consensus, Compcos metrics re-weighted to reflect headline (CEN) companies fiscal year end

Figure 8. Consensus EPS Momentum


Source: Forsyth Barr analysis, Bloomberg

Figure 9. 12 Month Forward PE


Source: Forsyth Barr analysis

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