

Contact Energy

OUTPERFORM

NZAS Creates Opportunity

Following the announcement that Rio Tinto (RIO) is undertaking a strategic review of NZAS, Contact Energy's (CEN) share price has declined -14%, which in our view is overdone such we are upgrading our rating to **OUTPERFORM**. Whilst NZAS closure would be a negative, we view that outcome as unlikely (less than 10%) and the share price reaction an overreaction.

What's changed?

- **Earnings:** FY20/FY21 EBITDAF -\$1m/-\$8m lower to \$466m/\$483m
- **Target Price:** Reduced -19cps (-2.3%) to \$8.03
- **Rating:** Upgraded to OUTPERFORM

Upgrade following significant share price fall

CEN's share price has dropped -14% following the announcement on 23 October than NZAS is undergoing a strategic review. Whilst we recognise there is downside risk to CEN, we view the risk of closure as unlikely. In addition, if NZAS were to close, over time we expect the electricity market to adjust, such that the negative effects of closure would be temporary. Nevertheless, until transmission constraints are resolved, CEN will face reduced generation volume and lower wholesale electricity prices, particularly in the lower South Island. Recognising the value impact of these risks, we have lowered our target price -19cps (-2.3%, 20% risk weighting for NZAS closing) to \$8.03. However, that is materially less than the share price reaction, hence, we believe CEN is currently offering the best value amongst the generator/retailers and we are upgrading our rating to OUTPERFORM from NEUTRAL.

CEN expected to offer some support to NZAS

With CEN one of the most affected if NZAS were to close, we expect it will offer a lower electricity price and that NZAS will accept the offer. This is the best case scenario. Our assumption is that it will offer to reduce its price -\$5/MWh, which equates to ~\$4.5m.

Tauhara geothermal development option to go on the back-burner

An indirect effect of NZAS threatening to close is the delay of new developments. However, with drilling at Tauhara currently delayed due to issues with the drilling rig and a decision on whether to go ahead with the project scheduled for after the NZAS strategic review, we do not see this as a significant issue for CEN.

Share price fall likely exacerbated by MSCI Index

Prior to the NZAS announcement, CEN had a better than even chance of entering the MSCI Index. However, we now seen that as unlikely (less than 20% chance) and hence we suspect part of the share price fall is investors who had bet on CEN's inclusion in the Index selling.

Investment View

Our rating is **OUTPERFORM**. We view CEN as offering the best value amongst the generator/retailers. We believe the NZAS closure risk is more than priced into the share price. CEN is offering an attractive dividend yield and has one of the best potential development projects (Tauhara) in the country.

NZX Code	CEN
Share price	NZ\$7.33
Target price	NZ\$8.03
Risk rating	Low
Issued shares	715.5m
Market cap	NZ\$5,245m
Average daily turnover	1,207k (NZ\$8,492k)

Share Price Performance



Financials: June	19A	20E	21E	22E
NPAT* (NZ\$m)	280.4	248.0	259.0	263.2
EPS* (NZc)	39.2	34.7	36.2	36.8
EPS growth* (%)	23.4	-11.5	4.4	1.6
DPS (NZc)	39.0	39.0	39.5	40.0
Imputation (%)	64	60	70	75

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	12.4	13.3	12.8	12.7
EV/EBIT	20.6	23.5	22.0	21.3
PE	18.7	21.2	20.3	19.9
Price / NTA	2.2	2.4	2.5	n/a
Cash dividend yield (%)	5.3	5.3	5.4	5.5
Gross dividend yield (%)	6.6	6.6	6.9	7.0

*Historic and forecast numbers based on underlying profits

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Contact Energy Limited (CEN)

Priced as at 06 Nov 2019: NZ\$7.33

June year end

Forsyth Barr valuation					Valuation Ratios					
Valuation methodology					2018A 2019A 2020E 2021E 2022E					
Blend of spot valuations, weighted to multiples					EV/EBITDA (x)	14.1	12.4	13.3	12.8	12.7
					EV/EBIT (x)	26.0	20.6	23.5	22.0	21.3
12-month target price (NZ\$)*	8.03	Spot valuations (NZ\$)			PE (x)	23.1	18.7	21.2	20.3	19.9
Expected share price return	9.5%	1. DCF	7.19		Price/NTA (x)	2.3	2.2	2.4	2.5	2.6
Net dividend yield	5.3%	2. Market multiples	7.99		Free cash flow yield (%)	5.7	6.4	4.7	5.5	5.6
Estimated 12-month return	14.9%	3. Dividend yield	8.89		Net dividend yield (%)	4.4	5.3	5.3	5.4	5.5
					Gross dividend yield (%)	5.2	6.6	6.6	6.9	7.0
Key WACC assumptions					DCF valuation summary (NZ\$m)					
Risk free rate	2.00%	Total firm value			6,336	Capital Structure				
Equity beta	0.88	(Net debt)/cash			(1,108)	2018A	2019A	2020E	2021E	2022E
WACC	6.6%	Value of equity			5,228	Interest cover EBIT (x)	3.3	4.8	5.0	5.3
Terminal growth	1.5%	Shares (m)			716	Interest cover EBITDA (x)	5.7	7.4	8.0	8.2
					Net debt/ND+E (%)	34.7	25.3	26.8	27.6	28.3
					Net debt/EBITDA (x)	3.0	1.8	2.1	2.0	2.0
Profit and Loss Account (NZ\$m)					Key Ratios					
Sales revenue	2,275	2,519	2,363	2,273	2,231	Return on assets (%)	4.9	9.8	5.4	6.0
Normalised EBITDA	479	518	466	483	490	Return on equity (%)	4.7	6.3	5.6	6.3
Depreciation and amortisation	(220)	(205)	(202)	(201)	(199)	Return on funds employed (%)	4.5	9.4	5.2	5.8
Normalised EBIT	259	313	264	282	291	EBITDA margin (%)	21.1	20.6	19.7	21.3
Net interest	(84)	(70)	(58)	(59)	(58)	EBIT margin (%)	11.4	12.4	11.2	12.4
Depreciation capex adjustment	99	104	100	98	96	Capex to sales (%)	3.6	2.5	3.9	2.9
Tax	(48)	(72)	(58)	(63)	(65)	Capex to depreciation (%)	37	31	46	32
Minority interests	-	-	-	-	-	Operating Performance				
Adjusted normalised NPAT	227	280	248	259	263	2018A	2019A	2020E	2021E	2022E
Abnormals/other	(97)	65	(100)	(98)	(96)	Wholesale electricity	1,157	1,463	1,336	1,215
Reported NPAT	130	345	148	161	167	Retail electricity	883	863	873	890
Normalised EPS (cps)	31.7	39.2	34.7	36.2	36.8	Retail gas sales	71	73	81	83
DPS (cps)	32.0	39.0	39.0	39.5	40.0	LPG sales	121	58	-	-
					Divisional Revenue (\$m)					
					Other					
					Total Revenue					
					2,263 2,489 2,323 2,221 2,170					
Growth Rates					Operating Statistics					
Revenue (%)	9.4	10.7	-6.2	-3.8	-1.8	Hydro generation (GWh)	3,479	4,232	3,722	3,887
EBITDA (%)	-4.4	8.1	-10.1	3.8	1.4	Geothermal generation (GWh)	3,323	3,257	3,346	3,346
EBIT (%)	-11.6	20.8	-15.8	7.2	3.1	Thermal generation (GWh)	1,812	1,422	1,694	1,704
Normalised NPAT (%)	9.1	23.4	-11.5	4.4	1.6	Total Generation (GWh)	8,614	8,911	8,763	8,937
Normalised EPS (%)	9.1	23.4	-11.5	4.4	1.6	GWAP (\$/MWh)	85	129	121	98
DPS (%)	23.1	21.9	0.0	1.3	1.3	Gas consumed (PJ)	17.5	13.9	16.1	16.1
Cash Flow (NZ\$m)					Gas price (\$/GJ)					
EBITDA	479	518	466	483	490	Retail electricity volumes (GWh)	6,997	6,554	6,108	6,234
Working capital change	38	(19)	(6)	(6)	(1)	Electricity customers (000)	413	411	411	408
Interest & tax paid	(111)	(112)	(117)	(126)	(131)	Average usage/customer (MWh)	8.7	8.6	8.6	8.6
Other	(27)	14	-	-	-	Average retail price (\$/MWh)	242	244	247	252
Operating cash flow	379	401	342	351	358	Balance Sheet (NZ\$m)				
Capital expenditure	(82)	(63)	(93)	(65)	(66)	Working capital	(22)	(3)	3	9
(Acquisitions)/divestments	6	382	-	-	-	Fixed assets	4,253	4,126	4,017	3,881
Other	(7)	-	-	-	-	Intangibles	441	425	425	425
Funding available/(required)	296	720	249	286	292	Other assets	404	132	132	132
Dividends paid	(201)	(251)	(279)	(279)	(283)	Total funds employed	5,076	4,680	4,577	4,447
Equity raised/(returned)	1	-	-	-	-	Net debt/(cash)	1,448	943	973	966
Increase/(decrease) in net debt	(96)	(469)	30	(7)	(9)	Other non current liabilities	901	955	950	941
					Shareholder's funds					
					Minority interests					
					Total funding sources					
					5,076 4,680 4,577 4,447 4,316					

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

Summary forecast changes

Figure 1. Summary forecast changes

	FY20			FY21			FY22		
	Old	New	% chg	Old	New	% chg	Old	New	% chg
Revenue	2,371	2,363	-0.4%	2,292	2,273	-0.8%	2,272	2,231	-1.8%
EBITDAF	467	466	-0.3%	491	483	-1.6%	502	490	-2.4%
EBIT	265	264	-0.5%	290	282	-2.7%	303	291	-4.0%
Reported NPAT	149	148	-0.6%	167	161	-3.6%	177	167	-5.3%
Normalised NPAT	149	148	-0.6%	167	161	-3.6%	177	167	-5.3%
Adjusted NPAT	249	248	-0.4%	265	259	-2.2%	272	263	-3.4%
EPS	34.8	34.7	-0.4%	37.0	36.2	-2.3%	38.1	36.8	-3.4%
DPS	39.0	39.0	0.0%	39.5	39.5	0.0%	40.0	40.0	0.0%
Generation (GWh)	8,763	8,763	0.0%	8,937	8,937	0.0%	9,018	9,018	0.0%
Electricity Wholesale Price (\$/MWh)	\$122.2	\$121.2	-0.8%	\$100.2	\$98.0	-2.2%	\$93.0	\$88.4	-4.9%
Retail Demand (GWh)	6,108	6,108	0.0%	6,234	6,234	0.0%	6,229	6,229	0.0%

Source: Forsyth Barr analysis

Investment summary

Our rating is **OUTPERFORM**. We view Contact Energy (CEN) as offering the best value amongst the generator/retailers. We believe the NZAS closure risk is more than priced into the share price. CEN is offering an attractive dividend yield and has one of the best potential development projects (Tauhara) in the country.

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

- **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.

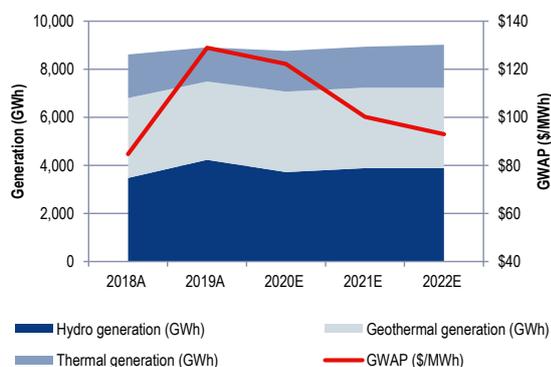
Key risks

- **Political/regulatory:** The 2014 election and recent Electricity Price Review (EPR) highlighted the political/regulatory risks inherent in the sector. Whilst the EPR gave the sector a thumbs up in most areas, the political risk is unlikely to ever disappear.
- **NZAS risk:** NZAS has indicated it is undertaking a strategic review, raising the possibility it may close. In our view, the smelter is unlikely to close (less than 10% chance) and the downside risks are fully factored into the share price.

Company description

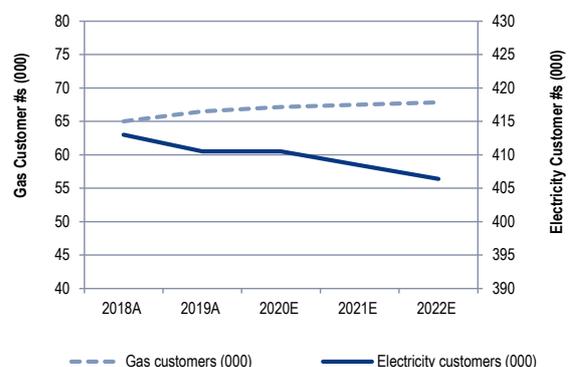
CEN generates around 25% of New Zealand's electricity and supplies electricity, gas and LPG to ~560,000 customers nationwide. Its generation portfolio consists of gas (a combined-cycle gas turbine and a gas-peaking plant), hydro (on the Clutha River in the South Island) and geothermal (in the central 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 2. Generation volumes and average generation price



Source: CEN, Forsyth Barr analysis

Figure 3. Customer numbers



Source: CEN, Forsyth Barr analysis

Figure 4. Substantial Shareholders

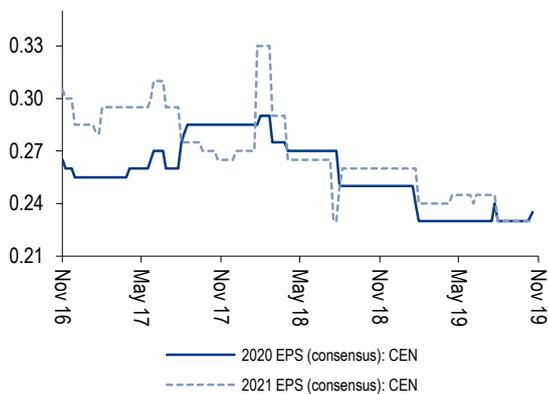
Shareholder	Latest Holding
No current substantial shareholders	

Figure 5. International Compcos

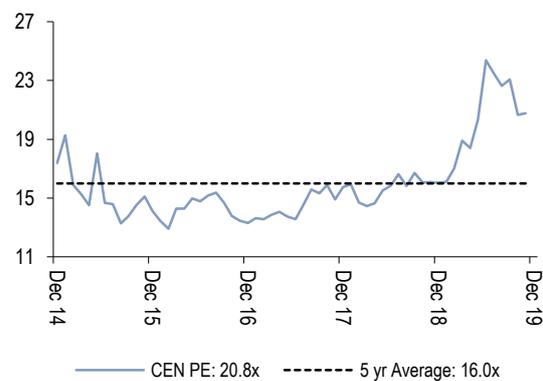
Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash D/Yld
<i>(metrics re-weighted to reflect CEN's balance date - June)</i>										
			(m)	2020E	2021E	2020E	2021E	2020E	2021E	2021E
Contact Energy	CEN NZ	NZ\$7.33	NZ\$5,245	21.2x	20.3x	13.3x	12.8x	23.5x	21.9x	5.4%
Genesis Energy *	GNE NZ	NZ\$3.18	NZ\$3,274	20.7x	16.7x	12.2x	11.0x	28.5x	23.1x	5.6%
Meridian Energy *	MEL NZ	NZ\$4.60	NZ\$11,790	24.6x	26.8x	16.1x	17.2x	25.9x	28.3x	4.7%
Mercury *	MCY NZ	NZ\$4.87	NZ\$6,634	26.9x	24.0x	15.0x	14.6x	24.7x	23.9x	3.3%
Trustpower *	TPW NZ	NZ\$8.26	NZ\$2,585	24.4x	23.5x	14.9x	14.4x	18.7x	18.0x	4.3%
AGL Energy	AGL AT	A\$19.66	A\$12,760	15.1x	15.1x	7.4x	7.3x	11.2x	11.4x	5.0%
ERM Power	EPW AT	A\$2.41	A\$603	12.1x	16.2x	7.1x	6.7x	10.1x	9.5x	4.2%
Origin Energy	ORG AT	A\$8.07	A\$14,213	13.7x	13.2x	6.3x	6.2x	13.8x	13.4x	4.5%
Compcro Average:				19.6x	19.4x	11.3x	11.1x	19.0x	18.2x	4.5%
CEN Relative:				+8%	+5%	+18%	+16%	+24%	+20%	+19%

EV = Current Market Cap + Actual Net Debt

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

Figure 6. Consensus EPS Momentum


Source: Forsyth Barr analysis, Bloomberg

Figure 7. 12 Month Forward PE


Source: Forsyth Barr analysis

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