New Zealand Equity Research | Utilities | Electricity generator/retailer
9 December 2019

FORSYTH BARR

Contact Energy

OUTPERFORM

When it Rains it Pours

Following ASM commentary that it has been a difficult start to FY20 for Contact Energy (CEN), the heavens opened, to the point where CEN has more water than it can handle. In addition, its deal to accelerate the removal of lower South Island transmission constraints and finalised 2020–2024 transmission prices lower than expected means it has been a good month for CEN. We have upgraded our FY20 EBTDAF forecast +$12m to $478m, lifted our target price +12cps to $8.15 and reiterate our OUTPERFORM rating.

What's changed?

- **Earnings:** FY20/FY21 EBITDAF lifted +$12m/+$12m to $478m/$495m
- **Target Price:** Increased +12cps to $8.15
- **Rating:** OUTPERFORM rating retained

Clutha spilling water after deluge

In the space of four weeks, CEN's hydro storage levels have gone from ~-100GWh (-39%) below average to +180GWh (+56%) above average. The only time CEN has had more water in its lakes was 20 years ago (almost exactly), and it is no surprise CEN is spilling water at present.

Deal to relieve lower South Island transmission constraints a positive

CEN and Meridian Energy have paid $5m each to Transpower in order for it to start work earlier than it otherwise would have on relieving lower South Island transmission constraints. Whilst the transmission lines will only constrain in the event the aluminium smelter (NZAS) closes, it is a significant positive as it materially reduces the amount of lost hydro generation if NZAS were to close. In addition, it improves CEN's negotiating position with NZAS (and the North Island generators). We have lowered our NZAS risk adjustment 3cps to -9cps.

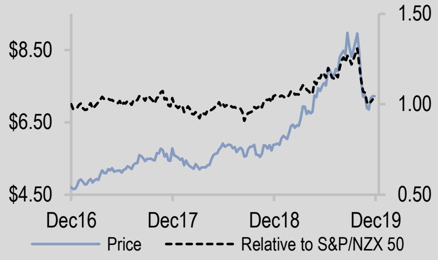
FY20 earnings uplift on more water, offset by Transpower payment

We have lifted our FY20 EBITDAF forecast +$12m (+2.7%) to $478m. The increase is largely due to the increase in hydro storage, offset by the -$5m payment to Transpower and the fact EBITDAF to the end of October was tracking worse than expected. Our FY21 EBITDAF forecast has also increased +$12m (+2.5%) to $495m, mainly due to lower transmission and distribution prices following the Commerce Commission's recent regulatory decisions.

The earnings uplifts and lower NZAS risk adjustment increases our target price +12cps (+1.5%) to $8.15.

NZX Code	CEN
Share price	NZ$7.23
Target price	NZ$8.15
Risk rating	Low
Issued shares	715.5m
Market cap	NZ$5,173m
Average daily turnover	1,290k (NZ$9,155k)

Share Price Performance



Financials: June	19A	20E	21E	22E
NPAT* (NZ$m)	280.4	257.6	267.6	265.8
EPS* (NZc)	39.2	36.0	37.4	37.1
EPS growth* (%)	23.4	-8.1	3.9	-0.7
DPS (NZc)	39.0	39.0	39.5	40.0
Imputation (%)	64	65	70	75

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	12.3	12.8	12.4	12.4
EV/EBIT	20.3	22.1	20.9	20.9
PE	18.5	20.1	19.3	19.5
Price / NTA	2.2	2.3	2.4	n/a
Cash dividend yield (%)	5.4	5.4	5.5	5.5
Gross dividend yield (%)	6.7	6.8	7.0	7.1

*Historic and forecast numbers based on underlying profits

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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.

Contact Energy Limited (CEN)	Priced as at 06 Dec 2019: NZ$7.23			June year end

Forsyth Barr valuation			
Valuation methodology	Blend of spot valuations, weighted to multiples		
12-month target price (NZ$)*	**8.15**	**Spot valuations (NZ$)**	
Expected share price return	12.7%	1. DCF	7.40
Net dividend yield	5.4%	2. Market multiples	8.26
Estimated 12-month return	18.2%	3. Dividend yield	8.54
Key WACC assumptions		**DCF valuation summary (NZ$m)**	
Risk free rate	2.00%	Total firm value	6,470
Equity beta	0.88	(Net debt)/cash	(1,108)
WACC	6.7%	Value of equity	5,363
Terminal growth	1.5%	Shares (m)	716

Profit and Loss Account (NZ$m)	2018A	2019A	2020E	2021E	2022E
Sales revenue	2,275	2,519	2,278	2,291	2,210
Normalised EBITDA	**479**	**518**	**478**	**495**	**493**
Depreciation and amortisation	(220)	(205)	(202)	(201)	(199)
Normalised EBIT	**259**	**313**	**276**	**294**	**294**
Net interest	(84)	(70)	(58)	(58)	(57)
Depreciation capex adjustment	99	104	100	98	96
Tax	(48)	(72)	(61)	(66)	(66)
Minority interests	-	-	-	-	-
Adjusted normalised NPAT	**227**	**280**	**258**	**268**	**266**
Abnormals/other	(97)	65	(100)	(98)	(96)
Reported NPAT	**130**	**345**	**157**	**170**	**170**
Normalised EPS (cps)	31.7	39.2	36.0	37.4	37.1
DPS (cps)	32.0	39.0	39.0	39.5	40.0

Growth Rates	2018A	2019A	2020E	2021E	2022E
Revenue (%)	9.4	10.7	-9.6	0.6	-3.5
EBITDA (%)	-4.4	8.1	-7.6	3.4	-0.4
EBIT (%)	-11.6	20.8	-11.7	6.3	0.0
Normalised NPAT (%)	9.1	23.4	-8.1	3.9	-0.7
Normalised EPS (%)	9.1	23.4	-8.1	3.9	-0.7
DPS (%)	23.1	21.9	0.0	1.3	1.3

Cash Flow (NZ$m)	2018A	2019A	2020E	2021E	2022E
EBITDA	**479**	**518**	**478**	**495**	**493**
Working capital change	38	(19)	(9)	(5)	(1)
Interest & tax paid	(111)	(112)	(121)	(129)	(131)
Other	(27)	14	-	-	-
Operating cash flow	**379**	**401**	**349**	**361**	**362**
Capital expenditure	(82)	(63)	(93)	(65)	(66)
(Acquisitions)/divestments	6	382	-	-	-
Other	(7)	-	-	-	-
Funding available/(required)	**296**	**720**	**256**	**296**	**295**
Dividends paid	(201)	(251)	(279)	(279)	(283)
Equity raised/(returned)	1	-	-	-	-
Increase/(decrease) in net debt	**(96)**	**(469)**	**23**	**(17)**	**(13)**

Balance Sheet (NZ$m)	2018A	2019A	2020E	2021E	2022E
Working capital	(22)	(3)	6	10	11
Fixed assets	4,253	4,126	4,017	3,881	3,748
Intangibles	441	425	425	425	425
Other assets	404	132	132	132	132
Total funds employed	**5,076**	**4,680**	**4,580**	**4,448**	**4,316**
Net debt/(cash)	1,448	943	966	949	936
Other non current liabilities	901	955	950	941	931
Shareholder's funds	2,727	2,782	2,664	2,558	2,449
Minority interests	-	-	-	-	-
Total funding sources	**5,076**	**4,680**	**4,580**	**4,448**	**4,316**

Valuation Ratios	2018A	2019A	2020E	2021E	2022E
EV/EBITDA (x)	13.9	12.3	12.8	12.4	12.4
EV/EBIT (x)	25.8	20.3	22.1	20.9	20.9
PE (x)	22.8	18.5	20.1	19.3	19.5
Price/NTA (x)	2.3	2.2	2.3	2.4	2.6
Free cash flow yield (%)	5.7	6.5	5.0	5.7	5.7
Net dividend yield (%)	4.4	5.4	5.4	5.5	5.5
Gross dividend yield (%)	5.3	6.7	6.8	7.0	7.1
Imputation (%)	48	64	65	70	75
Pay-out ratio (%)	101	100	108	106	108

Capital Structure	2018A	2019A	2020E	2021E	2022E
Interest cover EBIT (x)	3.3	4.8	5.2	5.5	5.6
Interest cover EBITDA (x)	5.7	7.4	8.3	8.5	8.6
Net debt/ND+E (%)	34.7	25.3	26.6	27.1	27.7
Net debt/EBITDA (x)	3.0	1.8	2.0	1.9	1.9

Key Ratios	2018A	2019A	2020E	2021E	2022E
Return on assets (%)	4.9	9.8	5.7	6.2	6.4
Return on equity (%)	4.7	6.3	5.9	6.6	6.9
Return on funds employed (%)	4.5	9.4	5.5	6.0	6.2
EBITDA margin (%)	21.1	20.6	21.0	21.6	22.3
EBIT margin (%)	11.4	12.4	12.1	12.8	13.3
Capex to sales (%)	3.6	2.5	4.1	2.8	3.0
Capex to depreciation (%)	37	31	46	32	33

Operating Performance	2018A	2019A	2020E	2021E	2022E
Divisional Revenue ($m)					
Wholesale electricity	1,157	1,463	1,254	1,235	1,127
Retail electricity	883	863	871	888	903
Retail gas sales	71	73	81	83	86
LPG sales	121	58	-	-	-
Other	31	32	33	33	33
Total Revenue	**2,263**	**2,489**	**2,238**	**2,239**	**2,149**
Operating Statistics					
Hydro generation (GWh)	3,479	4,232	4,117	3,887	3,887
Geothermal generation (GWh)	3,323	3,257	3,346	3,346	3,346
Thermal generation (GWh)	1,812	1,422	1,508	1,704	1,784
Total Generation (GWh)	**8,614**	**8,911**	**8,971**	**8,937**	**9,018**
GWAP ($/MWh)	85	129	112	101	87
Gas consumed (PJ)	17.5	13.9	14.4	16.1	16.9
Gas price ($/GJ)	6.1	7.1	7.2	7.3	7.4
Retail electricity volumes (GWh)	6,997	6,554	5,948	6,188	6,183
Electricity customers (000)	413	411	411	408	406
Average usage/customer (MWh)	8.7	8.6	8.6	8.6	8.6
Average retail price ($/MWh)	242	244	247	252	257
LWAP ($/MWh)	91	138	122	110	94
LWAP/GWAP	1.07	1.07	1.09	1.09	1.08
Retail gas volumes (PJ)	2.9	3.1	3.2	3.2	3.2
Gas customers (000)	65	67	67	68	68
Average gas sales price ($/GJ)	24.6	23.6	25.5	26.0	26.5

* 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	2,363	2,278	-3.6%	2,273	2,291	0.8%	2,231	2,210	-0.9%
EBITDAF	**466**	**478**	**2.8%**	**483**	**495**	**2.3%**	**490**	**493**	**0.5%**
EBIT	264	276	4.9%	282	294	4.0%	291	294	0.9%
Reported NPAT	148	157	6.5%	161	170	5.4%	167	170	1.6%
Normalised NPAT	**148**	**157**	**6.5%**	**161**	**170**	**5.4%**	**167**	**170**	**1.6%**
Adjusted NPAT	248	258	3.9%	259	268	3.3%	263	266	1.0%
EPS	34.7	36.0	3.8%	36.2	37.4	3.3%	36.8	37.1	1.0%
DPS	39.0	39.0	0.0%	39.5	39.5	0.0%	40.0	40.0	0.0%
Generation (GWh)	8,763	8,971	2.4%	8,937	8,937	0.0%	9,018	9,018	0.0%
Electricity Wholesale Price ($/MWh)	$121.2	$111.6	-7.9%	$98.0	$100.9	3.0%	$88.4	$86.8	-1.7%
Retail Demand (GWh)	6,108	5,948	-2.6%	6,234	6,188	-0.7%	6,229	6,183	-0.7%

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.

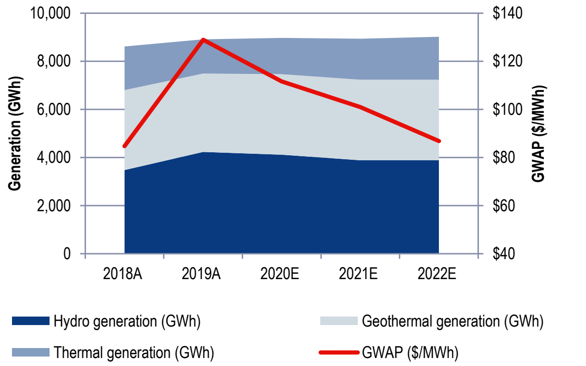
Key risks

- **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

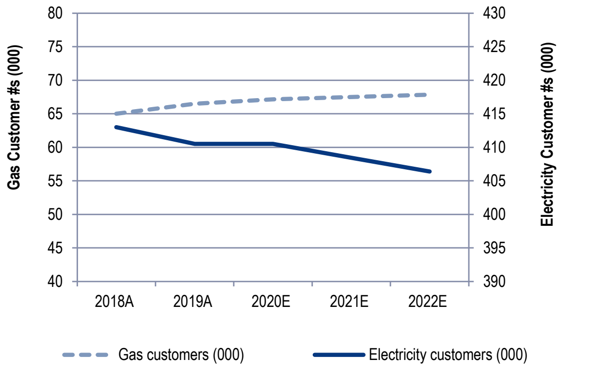
CEN generates around 25% of New Zealand's electricity and supplies electricity, gas and LPG to ~560,000 customers nationwide. Its generation portfolio consists of gas (a combined-cycle gas turbine and a gas-peaking plant), hydro (on the Clutha River in the South Island) and geothermal (in the central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

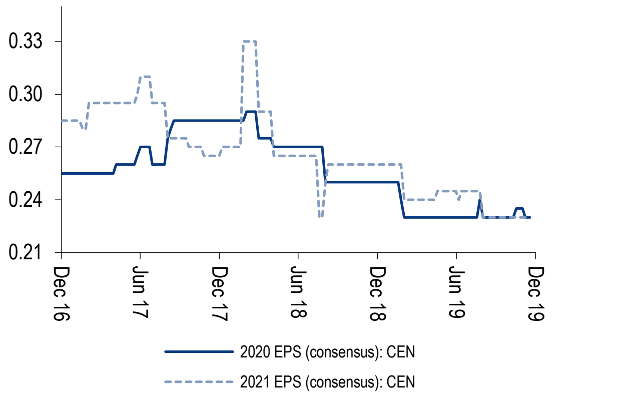
No current substantial shareholders

Figure 5. International Compcos

Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash D/Yld
(metrics re-weighted to reflect CEN's balance date - June)			(m)	2020E	2021E	2020E	2021E	2020E	2021E	2021E
Contact Energy	**CEN NZ**	**NZ$7.23**	**NZ$5,173**	**20.1x**	**19.3x**	**12.8x**	**12.4x**	**22.1x**	**20.8x**	**5.5%**
Genesis Energy *	GNE NZ	NZ$3.09	NZ$3,181	20.3x	16.0x	12.0x	10.7x	28.3x	22.3x	5.7%
Meridian Energy *	MEL NZ	NZ$4.96	NZ$12,712	26.6x	29.8x	17.3x	18.8x	27.9x	31.4x	4.4%
Mercury *	MCY NZ	NZ$4.78	NZ$6,512	26.1x	23.5x	14.7x	14.4x	24.2x	23.5x	3.4%
Trustpower *	TPW NZ	NZ$7.21	NZ$2,257	23.2x	21.7x	13.8x	13.3x	17.1x	16.4x	4.8%
AGL Energy	AGL AT	A$20.24	A$13,055	15.6x	15.6x	7.5x	7.5x	11.5x	11.6x	4.9%
ERM Power	EPW AT	A$2.41	A$603	12.5x	15.4x	7.0x	6.6x	10.0x	9.3x	4.4%
Origin Energy	ORG AT	A$8.53	A$15,023	14.3x	13.8x	6.4x	6.4x	15.7x	15.5x	4.5%
			Compco Average:	**19.8x**	**19.4x**	**11.2x**	**11.1x**	**19.2x**	**18.6x**	**4.6%**
EV = Current Market Cap + Actual Net Debt			**CEN Relative:**	**+1%**	**-0%**	**+14%**	**+11%**	**+15%**	**+12%**	**+20%**

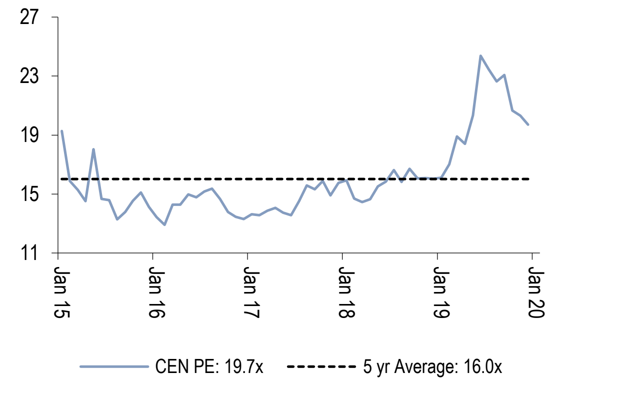
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (CEN) companies fiscal year end

Figure 6. Consensus EPS Momentum



Source: Forsyth Barr analysis, Bloomberg

Figure 7. 12 Month Forward PE



Source: Forsyth Barr analysis