

Contact Energy

OUTPERFORM

Conviction List stock

Heavy Rain Evaporates

Contact Energy's (CEN) December 2019 operating performance showed little sign of benefitting from the strong hydro inflows in November and December. December hydro generation was barely above average, the heavy rain seemingly evaporating. We have cut our FY20 EBITDAF forecast materially **-\$34m (-7.1%) to \$444m** and our target price is **-30cps (-3.7%) lower to \$7.85**.

What's changed?

- **Earnings:** FY20 EBITDAF cut **-\$34m (-7.1%) to \$444m**
- **Target Price:** Reduced **-30cps (-3.7%) to \$7.85**
- **Rating:** OUTPERFORM rating retained

Heavy November/December rains have not appeared in operating stats

December 2019 hydro generation volumes disappointed. At 345GWh, this is just +1% above average. Yet, CEN reported that December hydro inflows were 202% of average and lake levels on 10 December were 156% of average. 2Q20 inflows were ~155% of average vs. 88% in the pcp. Yet, 2Q20 hydro generation was -9% lower than the pcp. Whilst CEN spilt plenty of water and held back some for generation in January, hydro generation was lower than expected.

Retail sales volumes were steady, with mass market volumes up +2% and the retail netback up +0.8% vs. pcp. Commercial volumes continue recent declines (as CEN has yet to re-enter the market) and were down -24% vs. pcp.

1H20 result expected to be soft

We estimate that December 2019 EBITDAF was \$34m, just +\$2m more than the pcp. Our 1H20 EBITDAF forecast is \$220m, **-\$57m lower than the pcp**. CEN is reporting its 1H20 result on Monday 10 February.

Significant earnings cuts on lower renewable generation volumes

The material **-\$34m** cut in our FY20 EBITDAF forecast is primarily **(-\$24m)** due to renewable generation volumes dropping **-275GWh**, reversing the upgrade we made in December following the heavy rain. Other factors contributing to reduced earnings are no signs of increasing commercial prices (the commercial netback in December 2019 was the same as December 2017 — **-\$5m**), commercial volumes a little lower than expected **(-\$3m)**, and higher corporate overhead costs **(-\$2m)**. These latter three factors also impact our longer-term forecasts, although that starts to reverse in FY22 as we assume CEN re-enters the commercial market.

The hit to near-term earnings has resulted in us lowering our target price **-30cps to \$7.85**.

Investment View

Our rating is OUTPERFORM. Notwithstanding another challenging year, we view CEN as offering some of 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\$7.42
Target price	NZ\$7.85
Risk rating	Low
Issued shares	715.5m
Market cap	NZ\$5,309m
Avg daily turnover	1,287k (NZ\$9,260k)

Share Price Performance



Financials	19A	20E	21E	22E
NPAT* (NZ\$m)	280.4	232.1	259.9	258.6
EPS* (NZc)	39.2	32.4	36.3	36.1
EPS growth* (%)	23.4	-17.2	12.0	-0.5
DPS (NZc)	39.0	39.0	39.5	40.0
Imputation (%)	64	55	70	70

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	12.5	14.1	13.0	13.0
EV/EBIT	20.8	25.9	22.1	22.0
PE	18.9	22.9	20.4	20.5
Price / NTA	2.3	2.4	2.5	n/a
Cash div yld (%)	5.3	5.3	5.3	5.4
Gross div yld (%)	6.6	6.4	6.8	6.9

*Historic/forecast numbers based on normalised profits

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Contact Energy Limited (CEN)
Priced as at 22 Jan 2020 (NZ\$)

7.42

12-month target price (NZ\$)*

7.85

Spot valuations (NZ\$)

Expected share price return	5.8%	1. DCF	7.03
Net dividend yield	5.3%	2. Market multiples	8.05
Estimated 12-month return	11.1%	3. Dividend yield	8.54

Key WACC assumptions

Risk free rate	2.00%
Equity beta	0.88
WACC	6.8%
Terminal growth	1.5%

DCF valuation summary (NZ\$m)

Total firm value	6,207
(Net debt)/cash	(1,108)
Less: Capitalised operating leases	
Value of equity	5,099

Profit and Loss Account (NZ\$m)

	2018A	2019A	2020E	2021E	2022E
Sales revenue	2,275	2,519	2,220	2,265	2,206
Normalised EBITDA	479	518	444	485	485
Depreciation and amortisation	-	(205)	(202)	(201)	(199)
Normalised EBIT	259	313	242	284	286
Net interest	(84)	(70)	(59)	(59)	(60)
Depreciation capex adjustment	99	104	100	98	96
Tax	(48)	(72)	(51)	(63)	(63)
Minority interests	-	-	-	-	-
Adjusted normalised NPAT	227	280	232	260	259
Abnormals/other	(97)	65	(100)	(98)	(96)
Reported NPAT	130	345	132	162	163
Normalised EPS (cps)	31.7	39.2	32.4	36.3	36.1
DPS (cps)	32.0	39.0	39.0	39.5	40.0

Valuation Ratios

	2018A	2019A	2020E	2021E	2022E
EV/EBITDA (x)	14.2	12.5	14.1	13.0	13.0
EV/EBIT (x)	26.3	20.8	25.9	22.1	22.0
PE (x)	23.4	18.9	22.9	20.4	20.5
Price/NTA (x)	2.3	2.3	2.4	2.5	2.7
Free cash flow yield (%)	5.6	6.4	4.4	5.4	5.4
Net dividend yield (%)	4.3	5.3	5.3	5.3	5.4
Gross dividend yield (%)	5.1	6.6	6.4	6.8	6.9

Capital Structure

	2018A	2019A	2020E	2021E	2022E
Interest cover EBIT (x)	3.3	4.8	4.5	5.2	5.2
Interest cover EBITDA (x)	5.7	7.4	7.6	8.2	8.1
Net debt/ND+E (%)	34.7	25.3	27.3	28.0	28.8
Net debt/EBITDA (x)	3.0	1.8	2.2	2.0	2.0

Growth Rates

	2018A	2019A	2020A	2021A	2022A
Revenue (%)	9.4	10.7	-11.9	2.0	-2.6
EBITDA (%)	-4.4	8.1	-14.3	9.3	-0.1
EBIT (%)	-11.6	20.8	-22.7	17.5	0.5
Normalised NPAT (%)	9.1	23.4	-17.2	12.0	-0.5
Normalised EPS (%)	9.1	23.4	-17.2	12.0	-0.5
Ordinary DPS (%)	23.1	21.9	0.0	1.3	1.3

Key Ratios

	2018A	2019A	2020E	2021E	2022E
Return on assets (%)	4.9	9.8	5.0	6.1	6.3
Return on equity (%)	4.7	6.3	5.0	6.4	6.8
Return on funds employed (%)	4.5	9.4	4.8	5.8	6.1
EBITDA margin (%)	21.1	20.6	20.0	21.4	22.0
EBIT margin (%)	11.4	12.4	10.9	12.6	13.0
Capex to sales (%)	3.6	2.5	4.2	2.9	3.0
Capex to depreciation (%)	n/a	31	46	32	33
Imputation (%)	48	64	55	70	70
Pay-out ratio (%)	101	100	120	109	111

Cash Flow (NZ\$m)

	2018A	2019A	2020E	2021E	2022E
EBITDA	479	518	444	485	485
Working capital change	38	(19)	(6)	(7)	(1)
Interest & tax paid	(111)	(112)	(112)	(127)	(130)
Other	(27)	14	-	-	-
Operating cash flow	379	401	327	351	355
Capital expenditure	(82)	(63)	(93)	(65)	(66)
(Acquisitions)/divestments	6	382	-	-	-
Other	(7)	-	-	-	-
Funding available/(required)	296	720	234	286	288
Dividends paid	(201)	(251)	(279)	(279)	(283)
Equity raised/(returned)	1	-	-	-	-
(Increase)/decrease in net debt	96	469	(46)	7	6

Operating Performance

	2018A	2019A	2020E	2021E	2022E
Hydro generation (GWh)	3,479	4,232	3,887	3,887	3,887
Geothermal generation (GWh)	3,323	3,257	3,302	3,324	3,324
Thermal generation (GWh)	1,812	1,422	1,594	1,700	1,781
Total Generation (GWh)	8,614	8,911	8,783	8,910	8,991
GWAP (\$/MWh)	85	129	111	101	88
Gas consumed (PJ)	17.5	13.9	15.0	15.9	16.6
Gas price (\$/GJ)	6.1	7.1	7.9	8.1	8.2

Balance Sheet (NZ\$m)

	2018A	2019A	2020E	2021E	2022E
Working capital	(22)	(3)	3	10	10
Fixed assets	4,253	4,126	4,017	3,881	3,748
Intangibles	441	425	425	425	425
Right of use asset	-	-	-	-	-
Other assets	404	132	132	132	132
Total funds employed	5,076	4,680	4,577	4,448	4,315
Net debt/(cash)	1,448	943	989	981	976
Lease liability	-	-	-	-	-
Other liabilities	901	955	950	941	931
Shareholder's funds	2,727	2,782	2,638	2,525	2,409
Minority interests	-	-	-	-	-
Total funding sources	5,076	4,680	4,577	4,448	4,315

	2018A	2019A	2020E	2021E	2022E
Retail electricity volumes (GWh)	6,997	6,554	5,888	6,121	6,163
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	119	109	94
LWAP/GWAP	1.07	1.07	1.07	1.08	1.07
Retail gas volumes (PJ)	2.9	3.1	3.1	3.1	3.2
Gas customers (000)	65	67	66	66	66
Average gas sales price (\$/GJ)	24.6	23.6	23.9	24.4	24.8

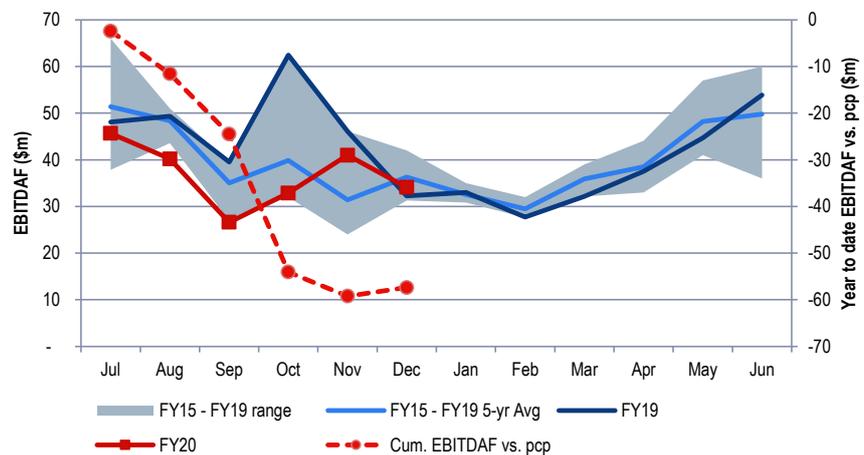
December operating performance

Figure 1. December 2019/1H20 EBITDAF breakdown

Summary	Dec-18	Dec-19	Difference		Year to date		Difference	
	\$m	\$m	\$m	%	FY19 \$m	FY20 \$m	\$m	%
Trading performance	2.7	0.1	(2.6)	-97%	45	23	(22)	-49%
Cost of generation	(29.1)	(20.8)	8.3	-28%	(164)	(171)	(7)	4%
Contracted wholesale sales	51.7	49.0	(2.7)	-5%	362	351	(11)	-3%
Wholesale	25.4	28.3	2.9	12%	243	203	(40)	-16%
Retail	9.1	8.0	(1.1)	-12%	47	30	(17)	-37%
Corporate costs (estimated)	(2.2)	(2.2)	0.0	0%	(13)	(13)	0	0%
Continuing operation EBITDAF	32.3	34.1	1.8	6%	278	220	(57)	-21%
LPG	0.0	0.0	0.0		13	0	(13)	-100%
Estimated EBITDAF	32.3	34.1	1.8	6%	291	220	(71)	-24%

Source: CEN, Forsyth Barr analysis

Figure 2. Historic EBITDAF



Source: CEN, Forsyth Barr analysis

Summary forecast changes

Figure 3. Summary forecast changes

	FY20			FY21			FY22		
	Old	New	% chg	Old	New	% chg	Old	New	% chg
Revenue	2,278	2,220	-2.5%	2,291	2,265	-1.1%	2,210	2,206	-0.2%
EBITDAF	478	444	-7.2%	495	485	-1.9%	493	485	-1.6%
EBIT	276	242	-12.4%	294	284	-3.2%	294	286	-2.6%
Reported NPAT	157	132	-16.2%	170	162	-4.5%	170	163	-4.2%
Adjusted NPAT	258	232	-9.9%	268	260	-2.9%	266	259	-2.7%
EPS	36.0	32.4	-9.9%	37.4	36.3	-2.9%	37.1	36.1	-2.7%
DPS	39.0	39.0	0.0%	39.5	39.5	0.0%	40.0	40.0	0.0%
Generation (GWh)	8,971	8,783	-2.1%	8,937	8,910	-0.3%	9,018	8,991	-0.3%
Electricity Wholesale Price (\$/MWh)	\$111.6	\$110.8	-0.8%	\$100.9	\$101.2	0.3%	\$86.8	\$87.8	1.1%
Retail Demand (GWh)	5,948	5,888	-1.0%	6,188	6,121	-1.1%	6,183	6,163	-0.3%

Source: Forsyth Barr analysis

Investment summary

Our rating is **OUTPERFORM**. Notwithstanding another challenging year, we view CEN as offering some of 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.

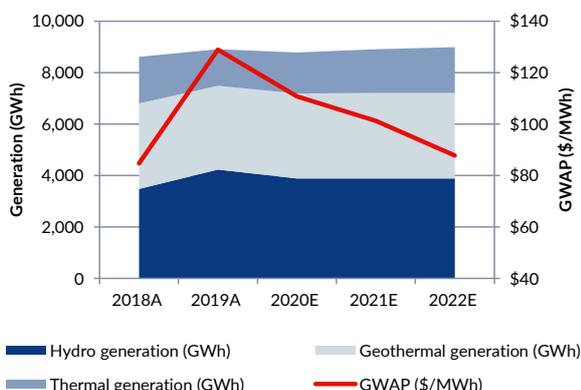
Key risks

- **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

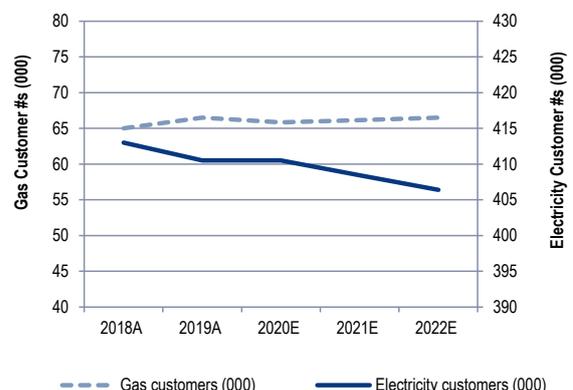
CEN generates around 25% of New Zealand's electricity and supplies electricity, gas and LPG to ~560,000 customers nationwide. Its generation portfolio consists of gas (a combined-cycle gas turbine and a gas-peaking plant), hydro (on the Clutha River in the South Island) and geothermal (in the central 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 4. Generation volumes and average price received



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	

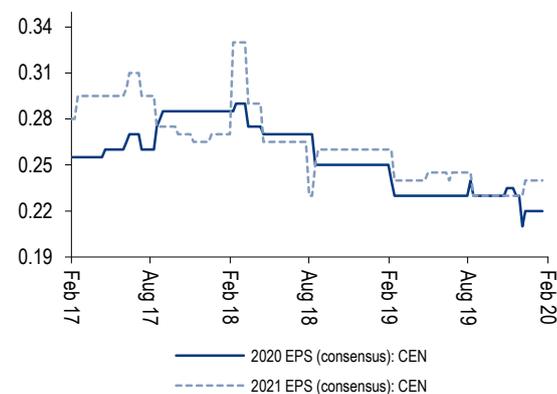
Figure 7. International Compcos

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>										
			(m)	2020E	2021E	2020E	2021E	2020E	2021E	2021E
Contact Energy	CEN NZ	NZ\$7.42	NZ\$5,309	22.9x	20.4x	14.1x	12.9x	25.8x	22.0x	5.3%
Genesis Energy *	GNE NZ	NZ\$3.21	NZ\$3,305	21.1x	16.7x	12.3x	11.0x	29.1x	22.9x	5.5%
Meridian Energy *	MEL NZ	NZ\$5.39	NZ\$13,815	26.9x	29.3x	17.7x	18.9x	27.5x	30.1x	4.1%
Mercury *	MCY NZ	NZ\$5.27	NZ\$7,179	28.8x	25.9x	16.0x	15.7x	26.3x	25.6x	3.1%
Trustpower *	TPW NZ	NZ\$7.46	NZ\$2,335	24.0x	22.5x	14.1x	13.7x	17.5x	16.8x	4.6%
AGL Energy	AGL AT	A\$20.42	A\$13,048	15.8x	15.9x	7.5x	7.5x	11.5x	11.7x	4.8%
ERM Power	EPW AT	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Origin Energy	ORG AT	A\$8.59	A\$15,129	14.2x	13.9x	6.4x	6.4x	15.0x	15.8x	4.4%
Compcos Average:				21.8x	20.7x	12.3x	12.2x	21.2x	20.5x	4.4%
CEN Relative:				+5%	-1%	+14%	+6%	+22%	+7%	+21%

EV = Current Market Cap + Actual Net Debt

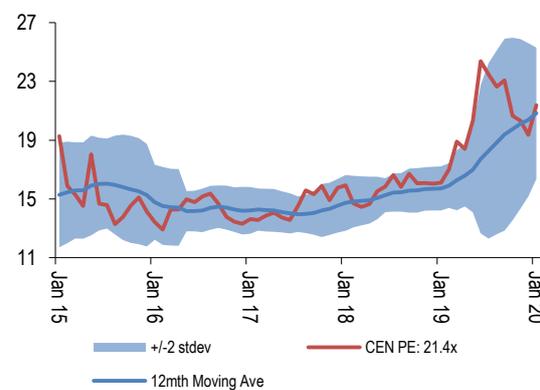
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compcos metrics re-weighted to reflect headline (CEN) companies fiscal year end

Figure 8. Consensus EPS Momentum



Source: Forsyth Barr analysis, Bloomberg

Figure 9. 12 Month Forward PE



Source: Forsyth Barr analysis

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