

Contact Energy

Damp Squib Confirmed – 1H20 Result Review

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OUTPERFORM 

Contact Energy's (CEN) 1H20 produced a damp squib of a result, with EBITDAF of \$221m the lowest 1H result since 2004. Whilst asset sales in 1H19 were responsible for -\$17m of the decline in earnings vs. pcp, weak hydrology, an abnormally strong pcp and gas constraints were largely responsible for the remaining -\$53m decline. Our short-term outlook (FY20 and FY21) is weaker, due mainly to the ongoing effects of the gas constraints limiting CEN's activity in the commercial and industrial (C&I) market. However, our longer-term outlook is more positive as the Tauhara geothermal project looks increasingly likely that it will get the go ahead, adding ~+35cps to our valuation. We have lifted our target price +15cps to \$8.00 and reiterate our OUTPERFORM rating.

NZX Code	CEN	Financials: Jun/	19A	20E	21E	22E	Valuation (x)	19A	20E	21E	22E
Share price	NZ\$7.22	NPAT* (NZ\$m)	277.5	231.9	248.8	252.8	EV/EBITDA	12.2	13.8	12.9	12.5
Target price	NZ\$8.00	EPS* (NZc)	38.8	32.4	34.8	35.3	EV/EBIT	20.2	27.0	25.0	24.8
Risk rating	Low	EPS growth* (%)	21.4	-16.4	7.3	1.6	PE	18.6	22.3	20.8	20.4
Issued shares	715.5m	DPS (NZc)	39.0	39.0	39.0	39.0	Price / NTA	2.2	2.3	2.5	n/a
Market cap	NZ\$5,166m	Imputation (%)	64	59	60	60	Cash div yld (%)	5.4	5.4	5.4	5.4
Avg daily turnover	1,259k (NZ\$9,143k)	*Based on normalised profits					Gross div yld (%)	6.7	6.6	6.7	6.7

Short-term outlook softer, but...

We have lowered our FY20 and FY21 EBITDAF forecast -\$3m and -\$12m to \$441m and \$473m respectively. These forecasts compare to CEN's normalised hydrology EBITDAF of \$480m. The main drivers of the short-term earnings cut are:

- Lower C&I pricing in the near-term as CEN does not expect to be able to re-enter the market until 1H21
- Higher gas costs from FY21 onwards as the new OMV Pohokura gas contract price is higher than expected at ~\$8/GJ

Tauhara lifts our long-term forecasts

Assuming NZAS remains open, CEN is sending strong signals that its Tauhara geothermal project is likely to go ahead. We now have sufficient confidence to include Tauhara in our forecasts, with earnings increasing from FY22. We assume CEN will build 140MW, which should add ~+\$70m to EBITDAF. We estimate that the cost of construction (~\$500m) is the equivalent of ~\$58/MWh (vs. long-dated North Island ASX prices of ~\$100/MWh). Tauhara will replace CEN's TCC gas plant which is expected to close in 2023.

Dividend flattened ahead of Tauhara uplift

Whilst our FY20 dividend forecast is unchanged at 39cps (and CEN reiterated dividend guidance of 39cps, highlighting its confidence in underlying EBITDAF earnings of \$480m), we have removed the modest dividend growth assumed in FY21 and FY22. However, our FY23 dividend forecast is up +2.5cps to 43cps following the commissioning of Tauhara, increasing a further +2.0cps to 45cps in FY24.

Contact Energy Limited (CEN)

Priced as at 10 Feb 2020 (NZ\$)

7.22
12-month target price (NZ\$)*
8.00

Expected share price return

10.8%

Net dividend yield

5.4%

Estimated 12-month return

16.2%

Spot valuations (NZ\$)

1. DCF

7.62

2. Market multiples

7.77

3. Dividend yield

8.43

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

6,604

(Net debt)/cash

(1,083)

Less: Capitalised operating leases

Value of equity

5,522

Profit and Loss Account (NZ\$m)	2018A	2019A	2020E	2021E	2022E
Sales revenue	2,275.0	2,519.0	2,167.8	2,229.2	2,245.5
Normalised EBITDA	479.0	518.0	441.4	473.0	489.9
Depreciation and amortisation	(220.0)	(205.0)	(215.5)	(228.3)	(243.0)
Normalised EBIT	264.0	313.0	225.9	244.7	246.9
Net interest	(84.0)	(70.0)	(56.3)	(58.5)	(68.5)
Depreciation capex adjustment	96	102	110	115	124
Tax	(48.0)	(72.0)	(48.0)	(52.1)	(50.0)
Minority interests					
Adjusted normalised NPAT	228.6	277.5	231.9	248.8	252.8
Abnormals/other	(94)	67	(108)	(115)	(124)
Reported NPAT	135.0	345.0	123.5	134.1	128.5
Normalised EPS (cps)	31.9	38.8	32.4	34.8	35.3
DPS (cps)	32.0	39.0	39.0	39.0	39.0

Growth Rates	2018A	2019A	2020A	2021A	2022A
Revenue (%)	9.4	10.7	-13.9	2.8	0.7
EBITDA (%)	-4.4	8.1	-14.8	7.2	3.6
EBIT (%)	-11.4	18.6	-27.8	8.3	0.9
Normalised NPAT (%)	9.0	21.4	-16.4	7.3	1.6
Normalised EPS (%)	9.0	21.4	-16.4	7.3	1.6
Ordinary DPS (%)	23.1	21.9	0.0	0.0	0.0

Cash Flow (NZ\$m)	2018A	2019A	2020E	2021E	2022E
EBITDA	479.0	518.0	441.4	473.0	489.9
Working capital change	37.0	(20.0)	(8.8)	9.7	18.8
Interest & tax paid	(110.0)	(111.0)	(108.6)	(116.0)	(119.3)
Other	(27.0)	14.0			
Operating cash flow	379.0	401.0	324.1	366.7	389.5
Capital expenditure	(82.0)	(63.0)	(89.0)	(215.0)	(416.3)
(Acquisitions)/divestments	6.0	382.0			
Other	(7.0)				
Funding available/(required)	296.0	720.0	235.1	151.7	(26.8)
Dividends paid	(201.0)	(251.0)	(279.1)	(279.1)	(279.1)
Equity raised/(returned)	1.0				
(Increase)/decrease in net debt	96.0	469.0	(44.1)	(127.4)	(306.0)

Balance Sheet (NZ\$m)	2018A	2019A	2020E	2021E	2022E
Working capital	(22.0)	(3.0)	4.8	(5.9)	(25.8)
Fixed assets	4,221.0	4,094.0	3,971.5	3,962.1	4,139.4
Intangibles	441.0	425.0	425.0	425.0	425.0
Right of use asset	32.0	32.0	32.0	32.0	32.0
Other assets	404.0	132.0	132.0	132.0	132.0
Total funds employed	5,076.0	4,680.0	4,565.2	4,545.2	4,702.7
Net debt/(cash)	1,410.0	918.0	962.1	1,089.5	1,395.5
Lease liability	38.0	25.0	25.0	25.0	25.0
Other liabilities	901.0	955.0	946.8	936.1	927.8
Shareholder's funds	2,727.0	2,782.0	2,631.3	2,494.6	2,354.4
Minority interests					
Total funding sources	5,076.0	4,680.0	4,565.2	4,545.2	4,702.7

Valuation Ratios	2018A	2019A	2020E	2021E	2022E
EV/EBITDA (x)	13.9	12.2	13.8	12.9	12.5
EV/EBIT (x)	25.2	20.2	27.0	25.0	24.8
PE (x)	22.6	18.6	22.3	20.8	20.4
Price/NTA (x)	2.3	2.2	2.3	2.5	2.7
Free cash flow yield (%)	5.7	6.5	4.6	2.9	-0.5
Net dividend yield (%)	4.4	5.4	5.4	5.4	5.4
Gross dividend yield (%)	5.3	6.7	6.6	6.7	6.7

Capital Structure	2018A	2019A	2020E	2021E	2022E
Interest cover EBIT (x)	3.4	4.9	4.4	4.8	4.2
Interest cover EBITDA (x)	5.7	7.4	7.8	8.1	7.2
Net debt/ND+E (%)	34.1	24.8	26.8	30.4	37.2
Net debt/EBITDA (x)	2.9	1.8	2.2	2.3	2.8

Key Ratios	2018A	2019A	2020E	2021E	2022E
Return on assets (%)	5.0	9.8	4.7	5.1	4.9
Return on equity (%)	4.9	6.3	4.6	5.4	5.5
Return on funds employed (%)	4.6	9.5	4.6	4.9	4.7
EBITDA margin (%)	21.1	20.6	20.4	21.2	21.8
EBIT margin (%)	11.6	12.4	10.4	11.0	11.0
Capex to sales (%)	3.6	2.5	4.1	9.6	18.5
Capex to depreciation (%)	37	31	41	94	171
Imputation (%)	48	64	59	60	60
Pay-out ratio (%)	100	101	120	112	110

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	3,753
Thermal generation (GWh)	1,812	1,422	1,530	1,700	1,781
Total Generation (GWh)	8,614	8,911	8,718	8,910	9,420
GWAP (\$/MWh)	85	129	105	101	88
Gas consumed (PJ)	17.5	13.9	14.4	15.9	16.6
Gas price (\$/GJ)	6.1	7.1	7.5	8.0	8.1
Retail electricity volumes (GWh)	6,997	6,554	5,888	6,121	6,370
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	245	250	255
LWAP (\$/MWh)	91	138	115	108	95
LWAP/GWAP	1.07	1.07	1.10	1.08	1.08
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	24.8	25.2

What's changed

Figure 1. Summary forecast changes

	FY20			FY21			FY22		
	Old	New	% chg	Old	New	% chg	Old	New	% chg
Revenue	2,220	2,168	-2.4%	2,265	2,229	-1.6%	2,206	2,246	1.8%
EBITDAF	444	441	-0.6%	485	473	-2.6%	485	490	1.0%
EBIT	242	226	-6.7%	284	245	-13.9%	286	243	-14.9%
Reported NPAT	132	124	-6.4%	162	134	-17.1%	163	126	-22.7%
Normalised NPAT	132	122	-7.5%	162	134	-17.1%	163	126	-22.7%
EPS	32.4	32.4	-0.1%	36.3	34.8	-4.3%	36.1	35.3	-2.2%
DPS	39.0	39.0	0.0%	39.5	39.0	-1.3%	40.0	39.0	-2.5%
Generation (GWh)	8,783	8,718	-0.7%	8,910	8,910	0.0%	8,991	9,420	4.8%
Electricity Wholesale Price (\$/MWh)	\$110.8	\$104.5	-5.7%	\$101.2	\$100.6	-0.6%	\$87.8	\$88.3	0.5%
Retail Demand (GWh)	5,888	5,888	0.0%	6,121	6,121	0.0%	6,163	6,370	3.4%

Source: Forsyth Barr analysis

Short-term earnings face more headwinds

We have trimmed our FY20 and FY21 EBITDAF forecast -\$3m and -\$12m to \$441m and \$473m respectively. The drivers of the near-term earnings declines are:

- An increase in gas costs from FY21 onwards (the gas contract announced today was at a cost of ~\$8/GJ, ~+\$0.5/GJ higher than expected). We are not convinced all of this will be able to be passed through to customers / recovered in the wholesale electricity market
- Trimming of C&I prices in the near-term as recontracting of C&I is not expected to commence until 1H21. We are, therefore, not expecting meaningful C&I price increases to come through until then
- Decline in the expected generation price received in 2H20 (impact on FY20 due to heavy rain in the past week – however, minimal impact on 2H20 hydro generation due to HVDC constraints in 3Q20 resulting in more water being spilled)

To provide an indicator of what 2H20 may look like the table below highlights FY20 EBITDAF under various scenarios. Our 2H20 forecast is -\$14m below CEN's implied 2H20 normalised hydrology EBITDAF. The main differences are the 2H20 HVDC constraints and CEN's \$234m normalised hydrology figure, assuming no gas constraints.

Figure 2. 2H20 scenarios

	1H20 EBITDAF (actual)	2H20 EBITDAF	Implied FY20 EBITDAF	Comment
Normalised 2H20 EBITDAF	221	234	455	CEN has indicated 1H20 normalised hydro EBITDAF is \$246m, implying 2H20 EBITDAF of \$234m
Actual 2H19 EBITDAF	221	226	447	2H19 EBITDAF was slightly below average, with C&I volumes starting their decline
Forsyth Barr 2H20	221	220	441	Falling wholesale electricity prices and gas constraints to continue to impact earnings for a while yet

Source: CEN, Forsyth Barr analysis

Long-term earnings to receive Tauhara boost

Whilst the short-term faces a few headwinds, it is increasingly clear CEN expects to close its Taranaki combined-cycle gas generation plant (TCC) and replace that with new generation from Tauhara, its large geothermal project. The clearest indication is CEN’s decision to accelerate depreciation on TCC, such that it will be fully depreciated by the end of FY23 (which is when TCC is expected to close). The replacement of TCC is almost a no-brainer. At the market gas price of \$8/GJ, carbon of \$28/tonne and operating costs of \$20/MWh, the running costs of TCC is ~\$95/MWh. That compares to our estimated long-run marginal cost of building Tauhara of \$58/MWh.

We are, therefore, now factoring in the construction of 140MW of Tauhara. Whilst Tauhara is consented for 250MW, we expect CEN will build it in stages so as to avoid unbalancing the wholesale electricity market too much. CEN indicated that tendering is going well and if all goes to plan, first power could be as soon as late 2021/early 2022. We assume the project costs \$500m to build.

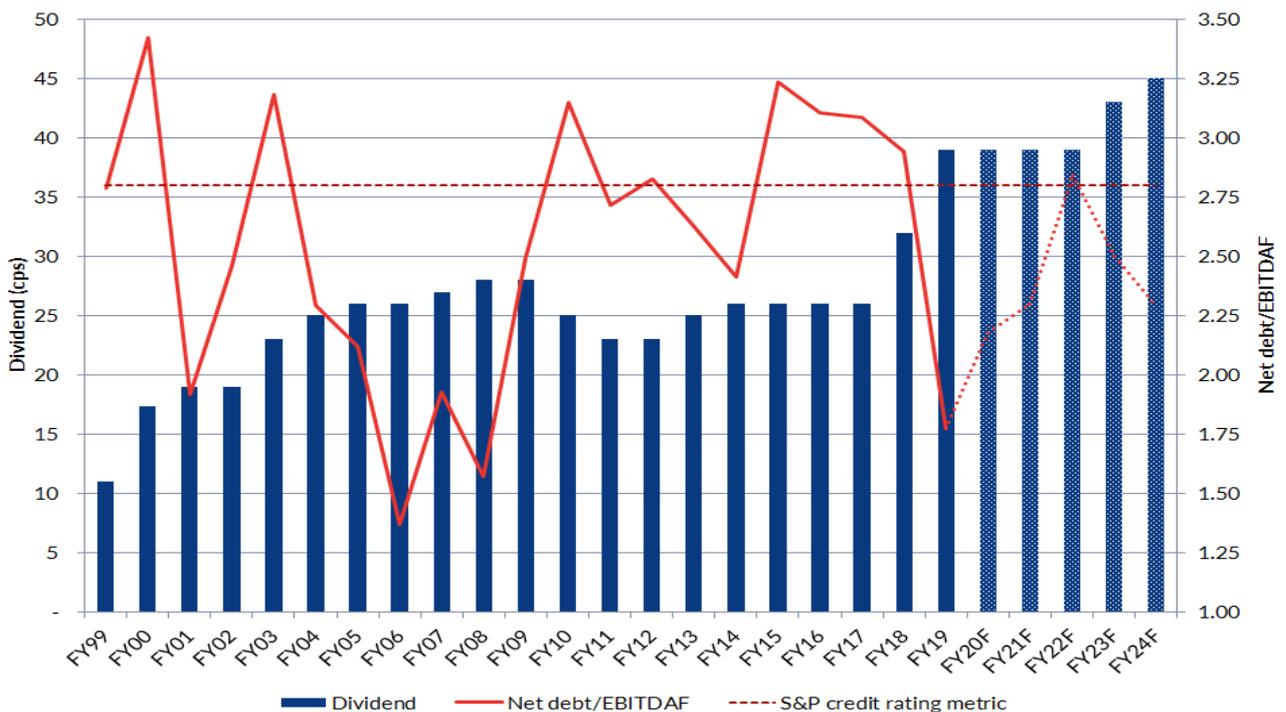
Our FY22 EBITDAF forecast is up slightly (+\$5m to \$490m), with the bigger increases coming in FY23 and beyond. We expect Tauhara’s EBITDAF uplift, once fully operational, to be ~+\$70m,

Dividend path flattened pre-Tauhara

CEN gave clear guidance that its dividend will be 39cps pending any step change in underlying earnings – which is expected to come from Tauhara. With the 1H20 result being so far below “normalised” earnings, there was a risk CEN could have trimmed its FY20 dividend. The decision not to trim the dividend points to management’s confidence in the long-term outlook, and its ability to deliver normalised hydrology earnings of \$480m.

Whilst we have flattened our dividend forecast, we have lifted it to 43cps in FY23 and 45cps in FY24 (and beyond) as Tauhara earnings kick-in. CEN’s cash dividend yield is 6.2% at 45cps.

Figure 3. CEN dividend and net debt/EBITDAF



Source: CEN, Forsyth Barr analysis

Target price lifts on long-term outlook

We have lifted our target price +15cps to \$8.00. Whilst we see near-term pressure on earnings (which may lead to some short-term share price volatility), the Tauhara project is a good one, with Stage 1 adding ~+35cps to our DCF valuation.

1H20 result commentary

Figure 4. 1H20 result summary

6 months ending 31 Dec	1H19 \$m	1H20 \$m	Chg %	FB \$m	Diff \$m	Comments
Wholesale elec sales	775	589	-24%	573	16	Drop in wholesale revenue due to lower wholesale electricity price
Retail elec sales	455	450	-1%	451	(1)	
Retail gas sales	41	42	2%	42	0	
Steam	16	17	6%	16	1	
LPG sales	58	-	-100%	-	0	LPG business sold in pcp
Broadband	2	7	250%	6	1	
Other Revenue	16	5	-69%	11	(6)	
Total Revenue	1,363	1,110	-19%	1,099	11	
Electricity purchases	499	365	-27%	356	9	Lower wholesale electricity prices lowered electricity purchases
Other direct costs	463	422	-9%	419	3	No LPG purchases the main driver of lower costs vs. pcp
Indirect operating costs	110	102	-7%	104	(2)	Most of decline in opex due to sale of LPG business – modest underlying opex fall
EBITDAF	291	221	-24%	220	1	
Depreciation & Amortisation	102	110	8%	101	9	Big increase in depreciation as CEN accelerates depreciation on TCC
Operating EBIT	189	111	-41%	119	(8)	
Abnormal items	174	-	-	-	0	PCP included significant gain on sale of assets
FV movements	(2)	2	-	-	2	
Net Interest	(39)	(28)	-28%	(30)	2	Fall vs. pcp due to asset sale proceeds. CEN has started capitalising interest costs to Tauhara (\$3m)
Pretax	322	85	-74%	89	(4)	
Tax	46	26	-43%	26	0	
REPORTED PROFIT	276	59	-79%	63	(4)	
Abnormal items	(169)	(1)	-	-	(1)	Gain on sale caused big PCP abnormal item
Normalised profit	107	58	-46%	63	(5)	
Normalised EPS	14.9	8.1	-46%	8.9	-0.8	Fall in normalised earnings due to lower EBITDAF and higher depreciation
Dividend per share	16.0	16.0	0%	16.0	0.0	Flat dividend as expected

Source: CEN, Forsyth Barr analysis

CEN has reported a weak 1H20 EBITDAF of \$221m, in line with expectations, but -\$70m lower than the pcp. The pcp was strong due to an abnormal period in October/November 2018 when CEN was able to sell into high wholesale electricity prices.

CEN has also reported a 1H20 interim dividend of 16cps (also as expected), imputed to 10cps. EPS of 8.1cps was -0.8cps lower than forecast, with higher depreciation costs being the main issue.

Key points

- The 1H20 EBITDAF result of \$221m was soft vs. pcp (\$291m) for a variety of reasons:
 - Sale of LPG business in 1H19 (-\$13m)
 - First period of full Ahuroa Gas Storage costs (-\$4m)
 - Favourable wholesale market conditions in 1H20 (-\$19m)
 - Below average hydro generation in 1H20 vs above average generation in the pcp (-\$10m)
 - Natural gas constraints impacting unit costs and thermal plant availability and ability to sell into the C&I market (-\$17m)
 - Market making gains in pcp not replicated in 1H20 (actually a slight negative) (-\$7m)
 - CEN has indicated that underlying normalised 1H EBITDAF should be ~\$246m.

- Depreciation costs were +\$9m higher than forecast as CEN has decided to accelerate depreciation on its TCC plant now that it appears highly likely that the plant will close at the end of FY23
- Interest costs were -\$2m lower than forecast as CEN has started to capitalise interest costs to the Tauhara project (\$3m in hydro)
- CEN has announced it has secured gas from OMV totalling 37PJ of gas to be delivered between 2021 to 2025. However, the contract price of the gas is ~\$8/GJ, more than expected. Nevertheless, the contract enables CEN to re-enter the C&I market as it now has certainty that it will be able to power its gas generation plant if required. (i.e. the risk of being short-generation has been alleviated).

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.

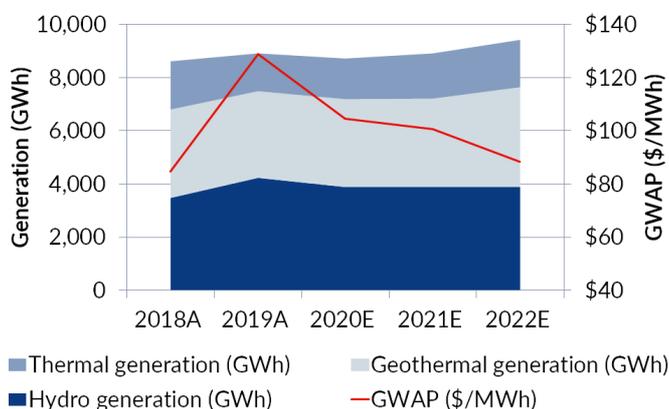
Upcoming catalysts/events

- **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

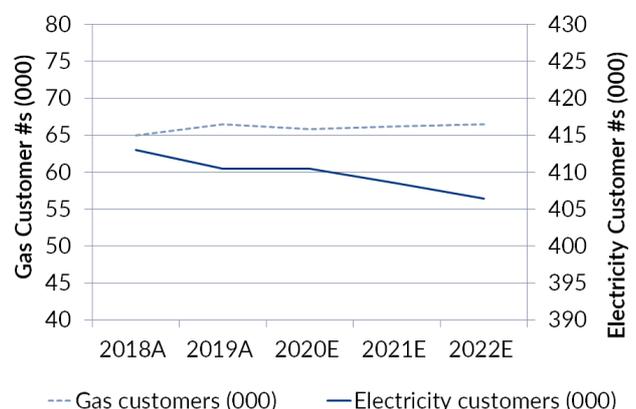
- **Political/regulatory:** The 2014 election and recent Electricity Price Review (EPR) highlighted the political/regulatory risks inherent in the sector. Whilst the EPR gave the sector a thumbs up in most areas, the political risk is unlikely to ever disappear.
- **NZAS risk:** NZAS has indicated it 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.

Figure 5. Generation volumes and average price received

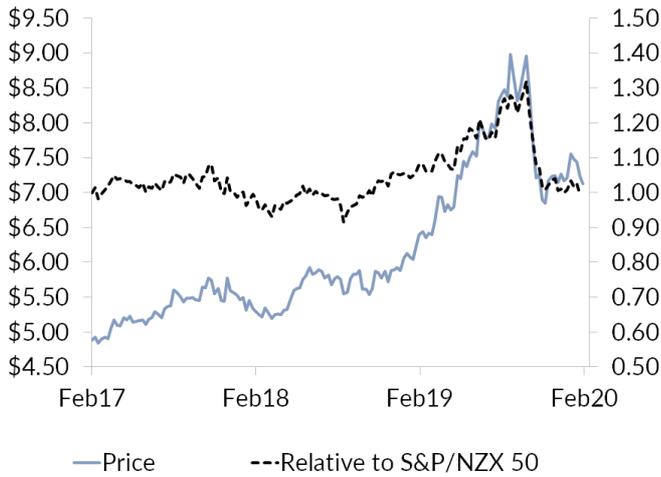


Source: CEN, Forsyth Barr analysis

Figure 6. Customer numbers



Source: CEN, Forsyth Barr analysis

Figure 7. Price Performance


Source: Forsyth Barr analysis

Figure 8. Substantial Shareholders

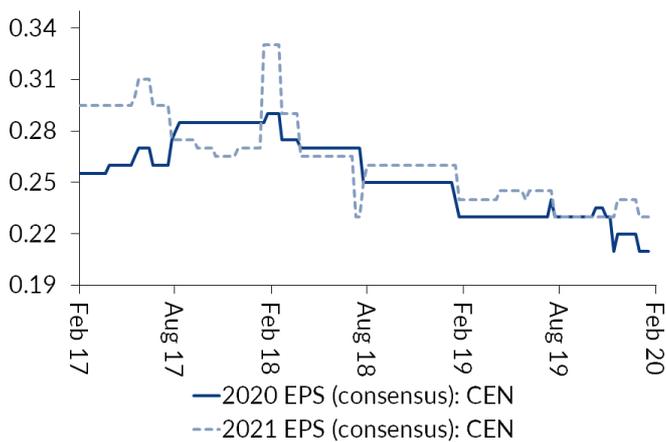
Shareholder	Latest Holding
No current substantial shareholders	

Figure 9. International valuation comparisons

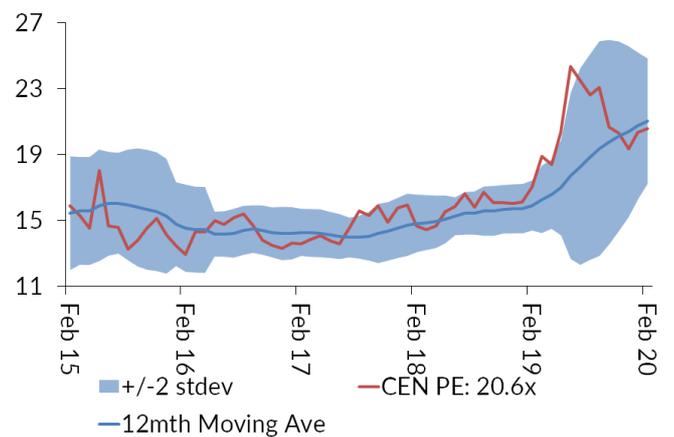
Company	Code	Price	Mkt Cap (m)	PE		EV/EBITDA		EV/EBIT		Cash D/Yld	
				2020E	2021E	2020E	2021E	2020E	2021E	2021E	
<i>(metrics re-weighted to reflect CEN's balance date - June)</i>											
Contact Energy	CEN NZ	NZ\$7.22	NZ\$5,166	22.3x	20.8x	13.8x	12.9x	26.9x	24.9x	5.4%	
Genesis Energy *	GNE NZ	NZ\$3.24	NZ\$3,330	21.6x	16.9x	12.5x	11.1x	30.5x	24.1x	5.5%	
Meridian Energy *	MEL NZ	NZ\$5.52	NZ\$14,148	27.6x	30.0x	18.0x	19.3x	28.1x	30.8x	4.0%	
Mercury *	MCY NZ	NZ\$5.30	NZ\$7,213	29.6x	26.5x	16.3x	15.9x	26.5x	25.8x	3.1%	
Trustpower *	TPW NZ	NZ\$7.45	NZ\$2,332	24.0x	22.4x	14.1x	13.6x	17.5x	16.8x	4.6%	
AGL Energy	AGL AT	A\$19.56	A\$12,499	15.2x	15.4x	7.3x	7.3x	11.2x	11.5x	4.9%	
Origin Energy	ORG AT	A\$7.74	A\$13,632	13.1x	12.9x	6.0x	6.1x	14.1x	14.6x	4.8%	
				Compco Average:	21.8x	20.7x	12.4x	12.2x	21.3x	20.6x	4.5%
				CEN Relative:	2%	0%	11%	5%	26%	21%	21%

EV = Current Market Cap + Actual Net Debt

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

Figure 10. Consensus EPS momentum


Source: Forsyth Barr analysis

Figure 11. 12 Month Forward PE


Source: Forsyth Barr analysis

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