Contact Energy
Dividend Decision Deferred — FY20 Result

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OUTPERFORM

Investors are being left to estimate Contact Energy's (CEN) sustainable dividend themselves, as CEN (to be fair understandably) turned down the opportunity to provide the market any guidance given ongoing NZAS uncertainty. We maintain our 32cps estimate, with news that Transpower has brought forward one year the completion date of the lower South Island transmission upgrade project, providing more confidence. CEN continues to offer good value and we retain our OUTPERFORM rating.

NZX Code	CEN
Share price	NZ$6.22
Target price	NZ$8.00
Risk rating	Low
Issued shares	715.5m
Market cap	NZ$4,451m
Avg daily turnover	1,158k (NZ$8,040k)

Financials: Jun/	20A	21E	22E	23E
NPAT* (NZ$m)	248.5	227.5	200.1	216.5
EPS* (NZc)	34.7	31.8	28.0	30.2
EPS growth* (%)	-10.4	-8.5	-12.0	8.2
DPS (NZc)	39.0	32.0	32.0	32.0
Imputation (%)	64	50	50	80
*Based on normalised profits				

Valuation (x)	20A	21E	22E	23E
EV/EBITDA	12.1	12.5	13.8	13.2
EV/EBIT	23.6	29.8	32.5	26.5
PE	17.9	19.6	22.2	20.6
Price / NTA	2.0	2.2	2.3	2.5
Cash div yld (%)	6.3	5.1	5.1	5.1
Gross div yld (%)	7.8	6.1	6.1	6.7

We will have to wait longer for dividend guidance — we maintain our 32cps dividend forecast

Given the fluid situation around NZAS, CEN is reviewing its dividend policy and has not provided FY21 dividend guidance. Whilst not a great surprise, it means investors are in the position of second guessing where CEN might land on this important valuation metric. We have left our dividend forecast unchanged at 32cps, which we view as sustainable through trough FY22 earnings. In our view, the share price is pricing in a dividend of ~26cps.

Transpower's announcement reduces trough earnings, but ASX futures curve has softened further

Transpower late last week said it expects to complete the lower South Island transmission project by May 2022 (12 months earlier than previously indicated), this both increases and brings forward trough earnings. The biggest change in our near-term forecasts is the +17% lift in FY23 EBITDAF to NZ$418m due to lower spill volumes, but also an assumption that retail prices will not fall as far. That said, curiously, the ASX futures curve is showing FY23 prices will be lower than FY22. We have lowered our FY21 EBITDAF forecast -NZ$9m (-2%) to NZ$437m due to CEN's Te Mihi geothermal plant undergoing significant scheduled maintenance. However, the improved medium-term outlook and reassessment of our cost of capital parameters lift our target price +50cps (+7%) to NZ$8.00.

Meeting peak North Island demand is the big issue, CEN contemplating a battery

Other than the lack of dividend guidance, the other significant take-out from CEN's result was its analysis of the position of the wholesale market in the North Island ex-NZAS. Its analysis suggests TCC and Genesis Energy's (GNE) Unit 5 will be surplus to meet New Zealand's GWh energy needs (we currently assume GNE's coal/gas Rankines Units close). In addition, to meet mid-winter peak demand, CEN is investigating a large-scale 100MW battery. Whilst CEN reiterated its Tauhara geothermal project is on hold, it is also clear that CEN is keen to build the project when conditions allow (i.e. as soon as possible).

FY20 result contained no surprises — down on FY19 but that was expected

The FY20 result itself contained few surprises, with EBITDAF of NZ$451m just +NZ$2m ahead of our forecast. The result was well down on the pcp due to asset sales, lower hydro conditions and weaker wholesale electricity prices. CEN's final dividend of 23cps is the same as FY19, whereas we had assumed CEN would take a more conservative approach.

FORSYTH BARR

Contact Energy Limited (CEN)

Priced as at 10 Aug 2020 (NZ$)	**6.22**

12-month target price (NZ$)*	**8.00**
Expected share price return	28.6%
Net dividend yield	5.1%
Estimated 12-month return	33.8%

Spot valuations (NZ$)	
1. DCF	8.19
2. Market multiples	7.44
3. Dividend yield	7.64

Key WACC assumptions	
Risk free rate	1.30%
Equity beta	0.92
WACC	5.7%
Terminal growth	1.5%

DCF valuation summary (NZ$m)	
Total firm value	6,899
(Net debt)/cash	(1,036)
Less: Capitalised operating leases	
Value of equity	5,863

Profit and Loss Account (NZ$m)	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
Sales revenue	2,519.0	2,073.0	1,932.1	1,697.4	1,665.7
Normalised EBITDA	**518.0**	**451.0**	**437.4**	**397.9**	**418.3**
Depreciation and amortisation	(205.0)	(220.0)	(253.1)	(228.7)	(210.8)
Normalised EBIT	**313.0**	**231.0**	**184.3**	**169.2**	**207.5**
Net interest	(70.0)	(55.0)	(58.5)	(59.9)	(56.5)
Depreciation capex adjustment	102	120	137	121	108
Tax	(72.0)	(46.0)	(35.2)	(30.6)	(42.3)
Minority interests	0	0	0	0	0
Adjusted normalised NPAT	**277.5**	**248.5**	**227.5**	**200.1**	**216.5**
Abnormals/other	67	(124)	(137)	(121)	(108)
Reported NPAT	**345.0**	**125.0**	**90.6**	**78.6**	**108.7**
Normalised EPS (cps)	38.8	34.7	31.8	28.0	30.2
DPS (cps)	39.0	39.0	32.0	32.0	32.0

Valuation Ratios	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
EV/EBITDA (x)	10.9	12.1	12.5	13.8	13.2
EV/EBIT (x)	18.0	23.6	29.8	32.5	26.5
PE (x)	16.0	17.9	19.6	22.2	20.6
Price/NTA (x)	1.9	2.0	2.2	2.3	2.5
Free cash flow yield (%)	7.6	5.4	5.6	5.9	5.3
Net dividend yield (%)	6.3	6.3	5.1	5.1	5.1
Gross dividend yield (%)	7.8	7.8	6.1	6.1	6.7

Capital Structure	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
Interest cover EBIT (x)	4.9	4.8	3.4	3.0	4.0
Interest cover EBITDA (x)	7.4	8.2	7.5	6.6	7.4
Net debt/ND+E (%)	26.2	28.3	30.4	30.7	31.7
Net debt/EBITDA (x)	1.9	2.3	2.4	2.6	2.5

Growth Rates	**2019A**	**2020A**	**2021A**	**2022A**	**2023A**
Revenue (%)	10.7	-17.7	-6.8	-12.2	-1.9
EBITDA (%)	8.1	-12.9	-3.0	-9.0	5.1
EBIT (%)	18.6	-26.2	-20.2	-8.2	22.7
Normalised NPAT (%)	21.4	-10.4	-8.5	-12.0	8.2
Normalised EPS (%)	21.4	-10.4	-8.5	-12.0	8.2
Ordinary DPS (%)	21.9	0.0	-17.9	0.0	0.0

Key Ratios	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
Return on assets (%)	9.8	4.6	3.9	3.8	4.8
Return on equity (%)	6.3	4.9	3.7	3.4	4.9
Return on funds employed (%)	9.3	4.4	3.8	3.6	4.6
EBITDA margin (%)	20.6	21.8	22.6	23.4	25.1
EBIT margin (%)	12.4	11.1	9.5	10.0	12.5
Capex to sales (%)	2.5	4.8	3.1	3.4	3.5
Capex to depreciation (%)	31	45	24	25	28
Imputation (%)	64	64	50	50	80
Pay-out ratio (%)	101	112	101	114	106

Cash Flow (NZ$m)	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
EBITDA	**518.0**	**451.0**	**437.4**	**397.9**	**418.3**
Working capital change	(20.0)	(24.0)	(6.4)	1.0	(4.6)
Interest & tax paid	(111.0)	(118.0)	(123.3)	(80.4)	(120.5)
Other	14.0	32.0	0	0	0
Operating cash flow	**401.0**	**341.0**	**307.8**	**318.5**	**293.2**
Capital expenditure	(63.0)	(100.0)	(60.0)	(57.0)	(58.1)
(Acquisitions)/divestments	382.0	(6.0)	0	0	0
Other	0	0	0	0	0
Funding available/(required)	**720.0**	**235.0**	**247.8**	**261.5**	**235.1**
Dividends paid	(251.0)	(280.0)	(279.1)	(229.0)	(229.0)
Equity raised/(returned)	0	0	0	0	0
(Increase)/decrease in net debt	**469.0**	**(45.0)**	**(31.4)**	**32.5**	**6.0**

Operating Performance	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
Hydro generation (GWh)	4,232	3,752	3,887	3,096	3,755
Geothermal generation (GWh)	3,257	3,331	3,074	3,324	3,324
Thermal generation (GWh)	1,422	1,360	1,349	385	385
Total Generation (GWh)	**8,911**	**8,443**	**8,310**	**6,804**	**7,463**
GWAP ($/MWh)	129	100	83	65	59
Gas consumed (PJ)	13.9	13.2	12.9	3.8	3.8
Gas price ($/GJ)	7.1	6.8	6.9	7.0	5.9
Retail electricity volumes (GWh)	6,554	5,694	5,624	5,579	5,412
Electricity customers (000)	411	418	411	403	395
Average usage/customer (MWh)	8.6	8.5	8.6	8.6	8.6
Average retail price ($/MWh)	191	199	201	194	193
LWAP ($/MWh)	136	108	90	72	64
LWAP/GWAP	1.06	1.08	1.08	1.11	1.10
Retail gas volumes (PJ)	3.1	3.0	3.0	3.0	3.0
Gas customers (000)	67	65	65	65	65
Average gas sales price ($/GJ)	23.6	24.5	25.4	25.8	24.8

Balance Sheet (NZ$m)	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
Working capital	(3.0)	19.0	23.4	20.4	23.0
Fixed assets	4,097.0	3,999.0	3,808.9	3,640.2	3,490.5
Intangibles	425.0	406.0	406.0	406.0	406.0
Right of use asset	29.0	27.0	27.0	27.0	27.0
Other assets	132.0	173.0	173.0	173.0	173.0
Total funds employed	**4,680.0**	**4,624.0**	**4,438.2**	**4,266.6**	**4,119.5**
Net debt/(cash)	990.0	1,036.0	1,067.4	1,034.9	1,028.9
Lease liability	25.0	22.0	22.0	22.0	22.0
Other liabilities	883.0	940.0	907.0	878.7	853.6
Shareholder's funds	2,782.0	2,626.0	2,441.9	2,330.9	2,215.1
Minority interests	0	0	0	0	0
Total funding sources	**4,680.0**	**4,624.0**	**4,438.2**	**4,266.6**	**4,119.5**

Forecast changes — medium-term outlook improved with Transpower accelerating lower South Island transmission project

The news that Transpower has been able to accelerate its lower South Island transmission project is great news for CEN. The project is now expected to be completed by May 2022, 12 months earlier than previously indicated and means CEN only faces transmission constraints for nine months of FY22. CEN is one of the most affected because of the anticipated spill from its Clutha River hydro dams.

There are several impacts on our forecasts from Transpower's announcement:

- Trough earnings are now expected in FY22, not FY23 and are expected to be higher then previously envisaged (NZ$398m vs. NZ$357m).
- Boosting the earnings outlook is:
  - Reduced water spill in total (mainly in FY23, but also a bit in FY22), therefore, more hydro generation in both years.
  - Higher wholesale electricity prices, particularly in the South Island (although this is not yet visible in the ASX futures market).
  - Higher retail prices as there is less time when wholesale electricity prices are suppressed.
- Greater earnings confidence increases the confidence around dividend sustainability.

Dividend outlook unchanged

Understandably, given the material changes about to hit the electricity market, CEN's dividend policy is under review. It has, therefore, not provided any dividend guidance for FY21. It also declined to indicate whether it will look through the trough earnings period (i.e. pitch dividends at a sustainable level on a ~three year time horizon), or whether it will allow dividends to track earnings more closely (and therefore be more volatile).

Our assumption remains unchanged from our initial analysis. We assume CEN will set its dividend at a level that is sustainable through the trough earnings period (FY22 in particular) and avoid any risk of a credit rating downgrade. It means paying a slightly lower dividend relative to FY21 earnings, but higher relative to FY22 earnings. We have left our dividend forecast unchanged at 32cps despite the moderate earnings increase. At 32cps, our forecasts assume debt levels decline slightly over the next five years (on aggregate) and that the net debt/EBITDAF ratio tops out at 2.6x in FY22, below the S&P metric of 2.8x.

Figure 1. Summary forecast earnings changes

	FY21			FY22			FY23		
NZ$m	**Old**	**New**	**% chg**	**Old**	**New**	**% chg**	**Old**	**New**	**% chg**
Revenue	1,955	1,932	-1.2%	1,701	1,697	-0.2%	1,661	1,666	0.3%
EBITDAF	**446**	**437**	**-2.0%**	**393**	**398**	**1.2%**	**357**	**418**	**17.3%**
EBIT	222	184	-17.1%	160	169	5.5%	117	208	77.9%
Reported NPAT	121	91	-25.4%	79	79	-0.1%	45	109	140.9%
Normalised NPAT	121	91	-25.4%	79	79	-0.1%	45	109	140.9%
Adjusted NPAT	233	227	-2.5%	196	200	2.2%	166	216	30.2%
EPS	32.6	31.8	-2.5%	27.4	28.0	2.2%	23.2	30.3	30.2%
DPS	32.0	32.0	0.0%	32.0	32.0	0.0%	32.0	32.0	0.0%
Generation (GWh)	8,302	8,310	0.1%	6,475	6,804	5.1%	6,475	7,463	15.3%
Electricity Wholesale Price ($/MWh)	$88.1	$83.4	-5.3%	$68.0	$64.7	-4.7%	$66.7	$58.8	-11.8%
Retail Demand (GWh)	5,537	5,624	1.6%	5,492	5,579	1.6%	5,438	5,412	-0.5%

Source: Forsyth Barr analysis

FY21 outlook is for another challenging year, ahead of NZAS closing

We have trimmed our FY21 forecast -$9m to NZ$437m. The main reason for the lower forecast is CEN undertaking scheduled statutory maintenance on Te Mihi, reducing expected geothermal generation ~-250GWh. That will be replaced (all other things being equal) with higher cost thermal generation.

Target price increased on improved outlook and cost of capital review

We have lifted our target price +50cps (+7%) to NZ$8.00. The main drivers of the target price increase are CEN's improved medium-term outlook and the reduction of our weighted average cost of capital (WACC) to 5.7% from 6.8% following a review of our WACC parameters. Our DCF valuation has increased +25% to NZ$8.19. Further details on the rationale behind the WACC changes can be found in our report, *The Cost of Capital Conundrum: When TINA Came to Our Shores*, published 7 August.

FY20 result analysis — no surprises

The FY20 result was in line with expectations, with only minor variances to our forecast throughout the P&L. The main difference was CEN's decision to continue paying a 39cps dividend, despite the upcoming earnings uncertainty. We had assumed CEN would take a more conservative approach, although Transpower's announcement late last week would have given it more confidence on its medium-term outlook.

Figure 2. Summary P&L analysis

12 months ending 30 June	FY19 NZ$m	FY20 NZ$m	Chg %	FB NZ$m	Diff $m	Comments
Wholesale elec sales	1,463	1,082	-26%	1,082	0	Down on pcp due to lower wholesale electricity prices and fall in commercial sales
Retail elec sales	863	860	0%	863	(3)	Mass market prices flat on pcp, with small decline in volumes
Retail gas sales	73	74	1%	75	(1)	
Steam	27	26	-4%	28	(2)	
LPG sales	58	-	-100%	-	0	Rockgas business sold in 1H19
Broadband	7	17	143%	17	0	Solid broadband uptake, but only breakeven at the gross profit level
Other revenue	28	14	-50%	12	2	
Total Revenue	**2,519**	**2,073**	**-18%**	**2,077**	**(4)**	
Electricity purchases	928	649	-30%	640	9	Decline due to lower commercial sales and lower wholesale electricity prices
Other direct costs	861	777	-10%	788	(11)	
Indirect operating costs	212	196	-8%	200	(4)	Good cost control, albeit $7m from LPG sale and $6m from COVID and lower bonuses
EBITDAF	**518**	**451**	**-13%**	**449**	**2**	See below for additional commentary on EBITDAF
Depreciation & amort	(205)	(220)	7%	(216)	(4)	Accelerated depreciation on TCC increased overall depreciation charge
Abnormal items	172	(5)		-	(5)	FY19 abnormal was gain on sale of assets (Rockgas and Ahuroa gas storage)
Fair value movements	2	-		2	(2)	
Total EBIT	**487**	**226**	**-54%**	**236**	**(10)**	
Net Interest	(70)	(55)	-21%	(56)	1	Lower interest rates, lower debt and capitalised interest contributed to lower total cost
Pretax	**417**	**171**	**-59%**	**180**	**(9)**	
Tax	(72)	(46)	-36%	(50)	4	
REPORTED PROFIT	**345**	**125**	**-64%**	**129**	**(4)**	
Abnormal items (net of tax)	(169)	4		(1)	5	
Normalised Profit	**176**	**129**	**-27%**	**128**	**1**	
Normalised EPS	24.6	18.0	-27%	17.9	0.1	
FY dividend per share (cps)	39.0	39.0	0%	32.0	7.0	CEN decided to maintain its dividend
Final dividend per share (cps)	23.0	23.0	0%	16.0	7.0	Final dividend of 23cps imputed to 15cps (65%)

Source: CEN, Forsyth Barr analysis

Other key points from the result:

- The significant decline in EBITDAF vs. FY19 came from:
  - Lower hydro generation volumes at lower wholesale electricity prices (FY19 benefitted from Pohokura gas outage)
  - CEN was unable to contract for gas (at acceptable prices), hence, it stepped out of the commercial and industrial market, resulting in sales volumes declining -28% vs. pcp
  - Relative to FY19, market making activities were not as profitable, down -NZ$10m
  - Offsetting the negative effects was the strong operating cost performance
- Relative to CEN's target NZ$480m EBITDAF under "normal" hydro conditions, the natural gas constraints caused most of the lower earnings.
- Operating fee cash flow of NZ$290m was down -NZ$51m on the pcp, due mainly to lower EBITDAF. Dividend cashflow payout ratio was 97%.

Investment Summary

Our rating is OUTPERFORM. We believe the NZAS closure is more than priced into the share price, and once transmission constraints are relieved we expect the company to be well positioned in the market. The sustainable gross dividend yield appears very attractive. CEN also continues to hold the best new generation project in the country in its Tauhara geothermal project.

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 FY21 and beyond — although the closure of NZAS helps reduce CEN's carbon emissions.

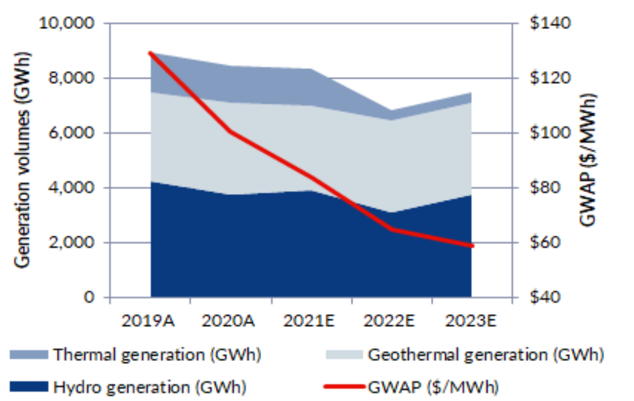
Upcoming catalysts/events

- **NZAS closure dynamics:** The announcement NZAS is closing has created significant uncertainty. The exact timing of closure and whether Transpower can upgrade transmission lines faster than announced are unknowns that could be positive. Whilst future wholesale electricity prices appear to be settling at a reasonable level, another key question is how that is factored into retail prices. Over the coming months there will be more clarity on some of these issues and the range of possible outcomes will narrow.

Risk factors

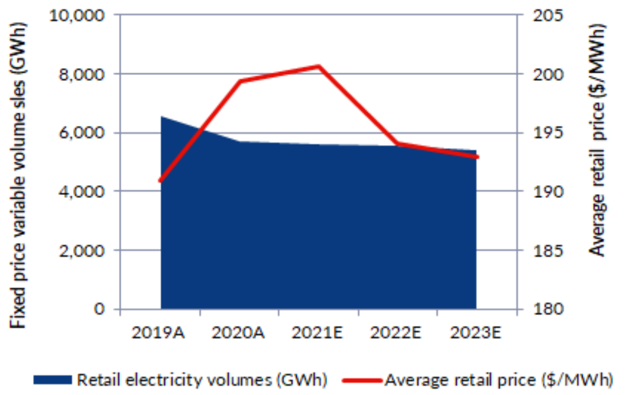
- **Negative undesirable trading situation (UTS) decision:** If the Electricity Authority upholds its draft decision, that is likely to suppress South Island prices during spill events, which we expect will become more prevalent after NZAS closes.

Figure 3. Generation volumes and average price received



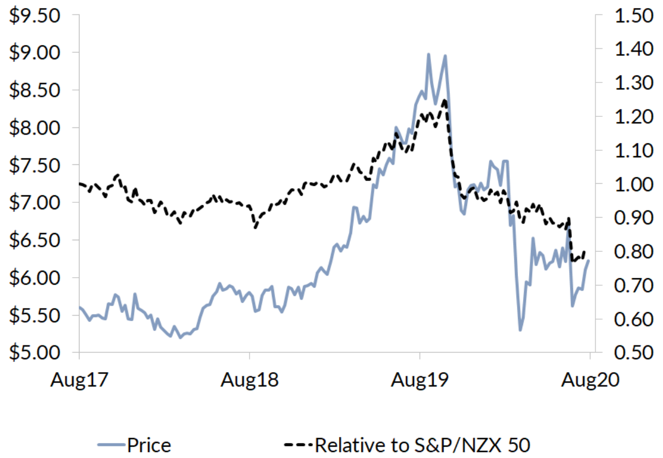
Source: CEN, Forsyth Barr analysis

Figure 4. Retail sales and average selling price



Source: CEN, Forsyth Barr analysis

Figure 5. Price performance



Source: IRESS, Forsyth Barr analysis

Figure 6. Substantial shareholders

Shareholder	Latest Holding
BlackRock Investment Management	5.4%
ACC	5.1%
The Vanguard Group	5.0%

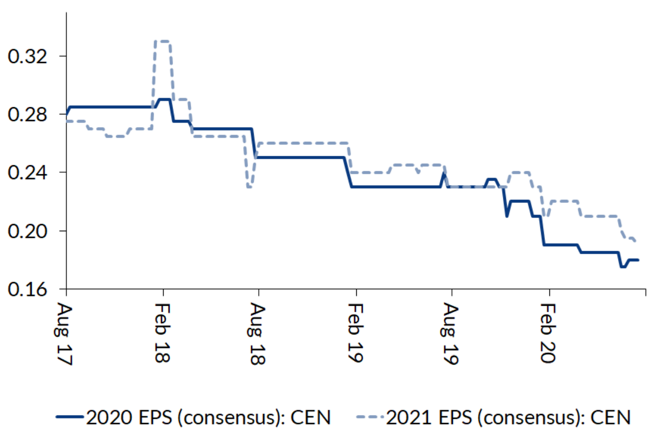
Source: NZX, Forsyth Barr analysis, NOTE: based on SPH notices only

Figure 7. International valuation comparisons

Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash Yld
(metrics re-weighted to reflect CEN's balance date - June)			(m)	2021E	2022E	2021E	2022E	2021E	2022E	2022E
Contact Energy	**CEN NZ**	**NZ$6.22**	**NZ$4,451**	**19.6x**	**22.2x**	**12.5x**	**13.8x**	**29.8x**	**32.4x**	**5.1%**
GENESIS ENERGY *	GNE NZ	NZ$2.86	NZ$2,967	19.3x	16.7x	12.0x	11.2x	33.2x	27.9x	4.9%
MERIDIAN ENERGY *	MEL NZ	NZ$4.83	NZ$12,364	24.8x	27.8x	16.0x	17.3x	25.2x	28.3x	3.5%
MERCURY *	MCY NZ	NZ$4.79	NZ$6,525	28.9x	25.9x	15.8x	15.3x	27.0x	26.5x	3.3%
TRUSTPOWER *	TPW NZ	NZ$6.80	NZ$2,128	24.3x	24.5x	14.4x	14.5x	19.2x	19.4x	4.4%
AGL ENERGY	AGL AT	A$16.84	A$10,475	13.1x	13.5x	6.4x	6.6x	10.0x	10.5x	5.5%
ORIGIN ENERGY	ORG AT	A$5.73	A$10,092	10.4x	19.2x	5.2x	6.5x	13.1x	20.2x	3.4%
			Compco Average:	**20.1x**	**21.3x**	**11.6x**	**11.9x**	**21.3x**	**22.1x**	**4.2%**
EV = Current Market Cap + Actual Net Debt			**CEN Relative:**	**-3%**	**5%**	**8%**	**16%**	**40%**	**46%**	**24%**

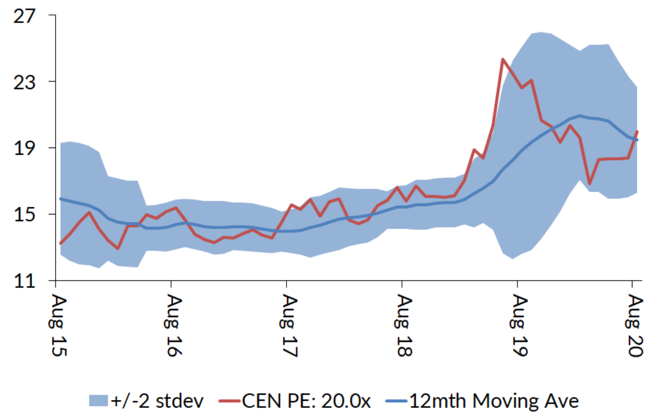
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (CEN) companies fiscal year end

Figure 8. Consensus EPS momentum (NZ$)



Source: Bloomberg, Forsyth Barr analysis

Figure 9. One year forward PE (x)



Source: IRESS, Forsyth Barr analysis

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