

# Contact Energy

## Geothermal Generates Equity Raise

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### OUTPERFORM

There were no shortage of announcements from Contact Energy (CEN) as it pushed go on its Tauhara geothermal project funded by an NZ\$400m equity raise, refreshed its dividend policy, released its 'no surprises' 1H21 result, and released a strong January 2021 operating result. In response, we have upgraded our rating to OUTPERFORM (we are looking through short-term ETF selling creating share price pressure) and upgraded near-term forecasts.

NZX Code	CEN	Financials: Jun/	20A	21E	22E	23E	Valuation (x)	20A	21E	22E	23E
Share price	NZ\$7.20	NPAT* (NZ\$m)	247.8	259.4	279.5	276.3	PE	20.8	20.7	19.9	20.1
Target price	NZ\$8.40	EPS* (NZc)	34.6	34.9	36.2	35.8	EV/EBIT	26.7	24.0	22.6	22.3
Risk rating	Low	EPS growth* (%)	-10.7	0.7	3.7	-1.1	EV/EBITDA	13.7	12.5	11.9	11.7
Issued shares	715.5m	DPS (NZc)	39.0	35.0	36.5	38.0	Price / NTA	2.3	2.3	2.4	2.5
Market cap	NZ\$5,152m	Imputation (%)	64	65	70	60	Cash div yld (%)	5.4	4.9	5.1	5.3
Avg daily turnover	1,366k (NZ\$9,712k)	*Based on normalised profits					Gross div yld (%)	6.8	6.1	6.4	6.5

#### What's changed?

- Earnings:** FY21/FY22/FY23 EBITDAF increased +NZ\$25m/+NZ\$31m/+NZ\$36m to NZ\$481m/NZ\$490m/NZ\$499m
- Target price and rating:** Target price lowered NZ\$0.70 (-7.7%) to NZ\$8.40. Rating upgraded to OUTPERFORM from NEUTRAL

#### Upgrading to OUTPERFORM as ETF flows provide buying opportunity

At the equity raise price of NZ\$7.00, CEN represents good value. It is trading on a sector low EBITDAF multiple and sector high dividend yield. Whilst expected ETF selling will likely place short-term downward pressure on CEN's share price, we view any further weakness as a buying opportunity. In upgrading our rating we look through any short-term share price pressure from ETF selling.

#### NZ\$400m equity raise to fund Tauhara development

As expected, CEN has pushed go on its 152MW Tauhara geothermal development. In a slight surprise, given hybrid debt would have been a cheaper funding option, CEN is funding the NZ\$580m project with NZ\$400m (+8%) of new equity. Whilst the equity raise strengthens CEN's balance sheet for future investments, arguably an equity raise could have happened at a later date, if required. When complete, Tauhara is expected to contribute ~+NZ\$85m EBITDAF, although with the Otahuhu FY24 forward price at NZ\$132/MWh, CEN's assumed selling price of NZ\$80/MWh appears conservative.

#### Resetting dividend policy to enable steady dividend growth

CEN has reset its dividend policy to 80%-100% of the last four years' average operating free cash flow. In essence, CEN is moving to a progressive dividend policy, and our revised dividend forecast assumes a +1.5cps increase per annum from the new 35cps base (which is -4cps lower than the old dividend and -1cps lower than our forecast).

#### No surprises in 1H21 result, January 2021 operating performance a strong start to 2H21

CEN's 1H21 EBITDAF of NZ\$246m was expected and +11% up on 1H20. CEN also released its Jan 2021 operating result with EBITDAF of NZ\$40m, +NZ\$9m higher than Jan 2020 and a new January record. A significant lift in wholesale electricity prices and retail prices is the main driver of our significant EBITDAF forecast increases. However, we emphasise these are short-term in nature. Our target price reduction of -NZ\$0.70 to NZ\$8.40 is a function of rising interest rates and our cost of capital increase.

## Contact Energy Limited (CEN)

Priced as at 15 Feb 2021 (NZ\$)

7.20

<b>12-month target price (NZ\$)*</b>	<b>8.40</b>
Expected share price return	16.7%
Net dividend yield	5.0%
Estimated 12-month return	21.7%

<b>Spot valuations (NZ\$)</b>	
1. DCF	8.35
2. Market multiples	8.29
3. Dividend yield	7.88

<b>Key WACC assumptions</b>	
Risk free rate	2.30%
Equity beta	0.84
WACC	5.4%
Terminal growth	1.5%

<b>DCF valuation summary (NZ\$m)</b>	
Total firm value	7,179
(Net debt)/cash	(1,201)
Less: Capitalised operating leases	
Value of equity	5,978

<b>Profit and Loss Account (NZ\$m)</b>	<b>2019A</b>	<b>2020A</b>	<b>2021E</b>	<b>2022E</b>	<b>2023E</b>
Sales revenue	2,519.0	2,073.0	2,308.9	2,330.9	2,250.3
<b>Normalised EBITDA</b>	<b>518.0</b>	<b>451.0</b>	<b>480.7</b>	<b>490.3</b>	<b>499.2</b>
Depreciation and amortisation	(205.0)	(220.0)	(229.8)	(232.0)	(236.7)
<b>Normalised EBIT</b>	<b>313.0</b>	<b>231.0</b>	<b>250.8</b>	<b>258.3</b>	<b>262.5</b>
Net interest	(70.0)	(55.0)	(54.4)	(41.1)	(53.2)
Depreciation capex adjustment	102	119	119	123	126
Tax	(72.0)	(46.0)	(57.5)	(60.8)	(58.6)
Minority interests	0	0	0	0	0
<b>Adjusted normalised NPAT</b>	<b>277.5</b>	<b>247.8</b>	<b>259.4</b>	<b>279.5</b>	<b>276.3</b>
Abnormals/other	67	(123)	(117)	(123)	(126)
<b>Reported NPAT</b>	<b>345.0</b>	<b>125.0</b>	<b>142.9</b>	<b>156.4</b>	<b>150.7</b>
Normalised EPS (cps)	38.8	34.6	34.9	36.2	35.8
DPS (cps)	39.0	39.0	35.0	36.5	38.0

<b>Valuation Ratios</b>	<b>2019A</b>	<b>2020A</b>	<b>2021E</b>	<b>2022E</b>	<b>2023E</b>
EV/EBITDA (x)	12.3	13.7	12.5	11.9	11.7
EV/EBIT (x)	20.4	26.7	24.0	22.6	22.3
PE (x)	18.6	20.8	20.7	19.9	20.1
Price/NTA (x)	2.2	2.3	2.3	2.4	2.5
Free cash flow yield (%)	6.6	4.7	5.0	2.5	-0.6
Net dividend yield (%)	5.4	5.4	4.9	5.1	5.3
Gross dividend yield (%)	6.8	6.8	6.1	6.4	6.5

<b>Capital Structure</b>	<b>2019A</b>	<b>2020A</b>	<b>2021E</b>	<b>2022E</b>	<b>2023E</b>
Interest cover EBIT (x)	4.9	4.8	5.0	7.0	5.3
Interest cover EBITDA (x)	7.4	8.2	8.8	11.9	9.4
Net debt/ND+E (%)	26.2	28.3	19.2	22.9	30.1
Net debt/EBITDA (x)	1.9	2.3	1.4	1.7	2.3

<b>Growth Rates</b>	<b>2019A</b>	<b>2020A</b>	<b>2021A</b>	<b>2022A</b>	<b>2023A</b>
Revenue (%)	10.7	-17.7	11.4	0.9	-3.5
EBITDA (%)	8.1	-12.9	6.6	2.0	1.8
EBIT (%)	18.6	-26.2	8.6	3.0	1.6
Normalised NPAT (%)	21.4	-10.7	4.7	7.7	-1.1
Normalised EPS (%)	21.4	-10.7	0.7	3.7	-1.1
Ordinary DPS (%)	21.9	0.0	-10.3	4.3	4.1

<b>Key Ratios</b>	<b>2019A</b>	<b>2020A</b>	<b>2021E</b>	<b>2022E</b>	<b>2023E</b>
Return on assets (%)	9.8	4.6	5.3	5.4	5.3
Return on equity (%)	6.3	4.9	4.9	5.7	5.7
Return on funds employed (%)	9.3	4.4	5.1	5.2	5.0
EBITDA margin (%)	20.6	21.8	20.8	21.0	22.2
EBIT margin (%)	12.4	11.1	10.9	11.1	11.7
Capex to sales (%)	2.5	4.8	3.7	11.0	18.8
Capex to depreciation (%)	31	45	37	111	179
Imputation (%)	64	64	65	70	60
Pay-out ratio (%)	101	113	100	101	106

<b>Cash Flow (NZ\$m)</b>	<b>2019A</b>	<b>2020A</b>	<b>2021E</b>	<b>2022E</b>	<b>2023E</b>
<b>EBITDA</b>	<b>518.0</b>	<b>451.0</b>	<b>480.7</b>	<b>490.3</b>	<b>499.2</b>
Working capital change	(20.0)	(24.0)	(6.2)	18.6	17.4
Interest & tax paid	(111.0)	(118.0)	(134.0)	(121.2)	(124.7)
Other	14.0	32.0	0	0	0
<b>Operating cash flow</b>	<b>401.0</b>	<b>341.0</b>	<b>340.5</b>	<b>387.7</b>	<b>391.9</b>
Capital expenditure	(63.0)	(100.0)	(85.0)	(257.0)	(423.1)
(Acquisitions)/divestments	382.0	(6.0)	0	0	0
Other	0	0	0	0	0
<b>Funding available/(required)</b>	<b>720.0</b>	<b>235.0</b>	<b>255.5</b>	<b>130.7</b>	<b>(31.2)</b>
Dividends paid	(251.0)	(280.0)	(301.4)	(270.5)	(282.1)
Equity raised/(returned)	0	0	400.0	0	0
<b>(Increase)/decrease in net debt</b>	<b>469.0</b>	<b>(45.0)</b>	<b>354.1</b>	<b>(139.8)</b>	<b>(313.3)</b>

<b>Operating Performance</b>	<b>2019A</b>	<b>2020A</b>	<b>2021E</b>	<b>2022E</b>	<b>2023E</b>
Hydro generation (GWh)	4,232	3,752	3,771	3,887	3,926
Geothermal generation (GWh)	3,257	3,331	3,139	3,324	3,457
Thermal generation (GWh)	1,422	1,360	1,279	1,138	977
<b>Total Generation (GWh)</b>	<b>8,911</b>	<b>8,443</b>	<b>8,189</b>	<b>8,348</b>	<b>8,360</b>
GWAP (\$/MWh)	129	100	143	146	130
Gas consumed (PJ)	13.9	13.2	12.2	10.8	9.3
Gas price (\$/GJ)	7.1	6.8	7.2	7.2	6.8

<b>Balance Sheet (NZ\$m)</b>	<b>2019A</b>	<b>2020A</b>	<b>2021E</b>	<b>2022E</b>	<b>2023E</b>
Working capital	(3.0)	19.0	23.2	2.6	(16.9)
Fixed assets	4,097.0	4,001.0	3,860.2	3,889.2	4,079.6
Intangibles	425.0	406.0	406.0	406.0	406.0
Right of use asset	29.0	25.0	25.0	25.0	25.0
Other assets	132.0	173.0	173.0	173.0	173.0
<b>Total funds employed</b>	<b>4,680.0</b>	<b>4,624.0</b>	<b>4,487.4</b>	<b>4,495.7</b>	<b>4,666.8</b>
Net debt/(cash)	990.0	1,036.0	681.9	821.7	1,135.0
Lease liability	25.0	22.0	22.0	22.0	22.0
Other liabilities	883.0	940.0	914.5	891.8	875.5
Shareholder's funds	2,782.0	2,626.0	2,868.9	2,760.2	2,634.3
Minority interests	0	0	0	0	0
<b>Total funding sources</b>	<b>4,680.0</b>	<b>4,624.0</b>	<b>4,487.4</b>	<b>4,495.7</b>	<b>4,666.8</b>

Retail electricity volumes (GWh)	6,554	5,694	5,257	5,194	5,201
Electricity customers (000)	411	418	401	401	401
Average usage/customer (MWh)	8.6	8.5	8.3	8.4	8.4
Average retail price (\$/MWh)	191	199	207	211	215
LWAP (\$/MWh)	136	108	157	160	142
LWAP/GWAP	1.06	1.08	1.10	1.10	1.09
Retail gas volumes (PJ)	3.1	3.0	2.9	2.9	2.9
Gas customers (000)	67	65	64	64	64
Average gas sales price (\$/GJ)	23.6	24.5	25.4	24.8	24.7

## NZ\$400m equity raise boosts balance sheet, but is arguably early

Whilst in our view CEN did not have to raise equity at this point, it creates balance sheet flexibility and is a strong signal that CEN expects to move into a development phase. It has signalled that after the NZ\$580m Tauhara development, it has a pipeline of projects that could see an additional NZ\$800m spent over the coming five years. The bulk of that NZ\$800m is an NZ\$700m, 167MW expansion of the Te Mihi geothermal plant, most of which will replace the aging Wairakei geothermal plant.

We do not expect the equity raise to materially impact CEN's S&P Global Clean Energy Index weighting as it will not materially affect CEN's 6-month median volume traded. All shares issued will be eligible for the 14cps interim dividend.

**Figure 1. Key equity raise details and timetable**

Offer size	NZ\$400m. NZ\$325m placement (underwritten) and NZ\$75m retail offer (non-underwritten) Under the retail offer, shareholders will be able to apply for up to NZ\$50,000/A\$46,500
Offer price	NZ\$7.00/share Retail offer price is the lower of NZ\$7.00 or -2.5% discount to the 5-day VWAP from Monday 1 March to Friday 5 March
<b>Placement key dates</b>	
Monday, 15 February	Trading halt commences and bookbuild undertaken
12:00pm, Tuesday 16 February	Placement results announced and trading halt lifted
Friday, 19 February	Placement shares allotted and trading commences on NZX & ASX
<b>Retail offer key dates</b>	
Friday, 12 February	Record date
Thursday, 18 February	Retail offer opens
Friday, 5 March	Retail offer closes and 5-day VWAP period ends
Thursday, 11 March	Retail offer results announced, including issue price
Friday, 12 March	Settlement date (NZX & ASX)
Friday, 12 March	Shares allotted and commence trading on NZX
Monday, 15 March	Shares allotted and commence trading on ASX

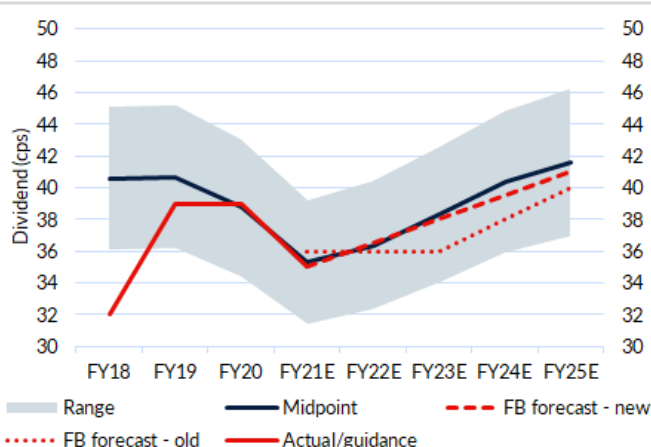
Source: CEN, Forsyth Barr analysis

## Dividend policy reset smooths future dividend growth path

CEN's new dividend policy is to pay between 80% and 100% of the average operating free cash flow of the preceding four years. Compared to the old policy (paying 100% of mean hydrology operating free cash flow), it provides CEN with more flexibility and smooths the future dividend path. The expected earnings uplift from Tauhara in FY24 will not be fully included in CEN's dividend until FY27. It also allows CEN to ride through natural earnings variability due to hydrology. Our revised dividend forecast assumes a +1.5cps increase from the revised 35cps starting base. The result is a more progressive dividend than under CEN's old policy.

In addition to the dividend policy change, CEN will commence a dividend reinvestment plan (DRP), starting at the FY21 result. The change in dividend policy and use of DRP is a further signal CEN intends to deploy significant capital over and above Tauhara.

**Figure 2. Dividend policy range and revised dividend forecast**



Source: Forsyth Barr analysis

**Figure 3. Summary forecast changes**

	FY21			FY22			FY23		
	Old	New	% chg	Old	New	% chg	Old	New	% chg
Revenue	2,169	2,309	6.5%	2,248	2,331	3.7%	2,187	2,250	2.9%
EBITDAF	456	481	5.4%	459	490	6.9%	463	499	7.9%
EBIT	202	251	24.0%	224	258	15.2%	242	263	8.4%
Reported NPAT	103	143	38.2%	115	156	36.5%	120	151	25.9%
Normalised NPAT	103	140	35.5%	115	156	36.5%	120	151	25.9%
Adjusted NPAT	241	259	7.7%	240	279	16.4%	234	276	17.9%
EPS	33.7	34.9	3.6%	33.6	39.1	16.4%	32.8	38.6	17.9%
DPS	36.0	35.0	-2.8%	36.0	36.5	1.4%	36.0	38.0	5.6%

Source: Forsyth Barr analysis

## Summary forecast changes

The key changes to our forecasts are:

- Increasing the short-term wholesale electricity price assumption in conjunction with increasing ASX futures prices. The average wholesale electricity price from FY21 to FY24 has increased between +NZ\$21/MWh and +NZ\$24/MWh.
- Flow through effects of higher wholesale electricity prices into retail and commercial prices. However, we do not assume a full pass through and expect retail margins to get squeezed. We cap retail price increases at +2.0% per annum.
- Adjusted Tauhara metrics, resulting in a modest increase in GWh generation volumes and an -NZ\$12m lower build cost.
- Assume CEN expands Te Mihi +167MW at a cost of NZ\$700m. Whilst the project size is ~2x bigger than our old assumption, the capex costs are ~2.5x greater, so is a modest value negative.

We note that hydro storage is currently below average and if conditions remain dry it will negatively impact CEN's FY21 (and potentially FY22) earnings. At this stage we assume normal hydro generation volumes, as 2H21 volumes are solid.

These assumption changes would have increased our DCF +5% to NZ\$9.55. However, cost of capital changes due to rising interest rates has more than offset the increased earnings outlook. Our DCF has in fact decreased -8% to NZ\$8.35. Our revised target price is down -8% to NZ\$8.40.

## 1H21 result commentary

Figure 4. Summary 1H21 result

6 months ending 31 Dec	1H20 NZ\$m	1H21 NZ\$m	Chg %	FB NZ\$m	Diff NZ\$m	Comments
Wholesale elec sales	589	615	4%	602	13	Firm wholesale electricity prices
Retail elec sales	450	446	-1%	447	(1)	Lower retail sales volumes the key driver of modest dip in revenue
Retail gas sales	42	42	0%	42	0	
Steam	17	17	0%	17	0	
Broadband	7	13	86%	14	(1)	Strong growth off a low base in broadband
Other Revenue	5	8	60%	6	2	
<b>Total Revenue</b>	<b>1,110</b>	<b>1,141</b>	<b>3%</b>	<b>1,128</b>	<b>13</b>	
Electricity purchases	(365)	(385)	5%	(386)	1	Higher wholesale electricity prices lifted electricity purchases
Other direct costs	(422)	(406)	-4%	(393)	(13)	Lower lines charges is the main reason for lower direct costs
Indirect operating costs	(102)	(104)	2%	(103)	(1)	Small increase on pcg
<b>EBITDAF</b>	<b>221</b>	<b>246</b>	<b>11%</b>	<b>246</b>	<b>0</b>	
Depreciation & amort.	110	114	4%	127	(13)	Lower than expected depreciation
<b>Operating EBIT</b>	<b>111</b>	<b>132</b>	<b>19%</b>	<b>119</b>	<b>13</b>	
Chg in value of fincl instrmnts	2	4		-	4	FV movements is something we don't forecast
Net Interest	(28)	(26)	-7%	(28)	2	CEN has started capitalising interest costs to Tauhara
<b>Pretax</b>	<b>85</b>	<b>110</b>	<b>29%</b>	<b>91</b>	<b>19</b>	
Tax	(26)	(32)	23%	(26)	(6)	
<b>Reported profit</b>	<b>59</b>	<b>78</b>	<b>32%</b>	<b>65</b>	<b>13</b>	
Abnormal items	(1)	(3)		-	(3)	
<b>Normalised profit</b>	<b>58</b>	<b>75</b>	<b>31%</b>	<b>65</b>	<b>10</b>	Lower depn charge is the main reason for better normalised NPAT than forecast
Normalised EPS	8.0	10.5	31%	9.1	1.4	
Dividend per share	16.0	14.0	-13%	15.0	-1.0	Fall in dividend following policy change

Source: CEN, Forsyth Barr analysis

Key points of note:

- The main driver of the better 1H21 result was increased hydro generation in 1Q21. Overall hydro generation was close to normal for 1H21.
- Reported retail EBITDAF was flat, with retail price increases offset by the internal wholesale electricity price charge.
- Broadband growth has been strong with revenue almost doubling due to a strong increase in customer numbers. However, broadband has yet to make any money for CEN and is unlikely to be a significant earnings contributor.
- Operating free cash flow increased +NZ\$37m (+31%) due to increased EBITDAF and release of working capital.
- The interim dividend of 14cps (9cps imputed) is -1cps lower than our forecast.

## Strong January 2021 operating performance

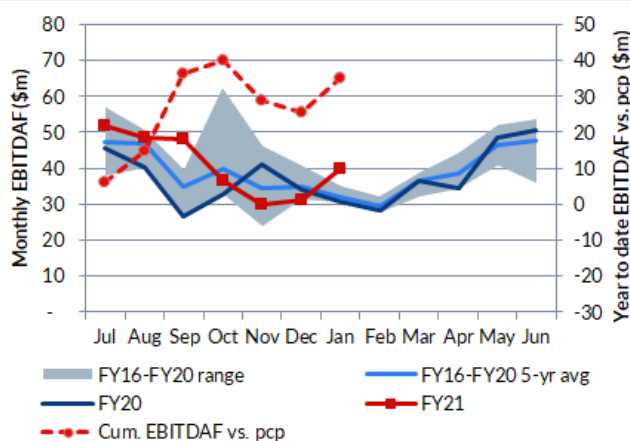
CEN also released its January 2021 operating report. January was a strong month for CEN and we calculate it made EBITDAF of NZ\$40m, +NZ\$9m higher than January 2020 (and the best January on record). The main driver of the strong performance is high wholesale electricity prices and good hydro generation volumes. The retail performance was also strong, with netback up a material +NZ\$15/MWh (+16%).

Figure 5. Estimated EBITDAF breakdown

Summary	Jan-20	Jan-21	Difference		Year to date		Difference	
	NZ\$m	NZ\$m	NZ\$m	%	FY20	FY21	NZ\$m	%
Trading performance	3	3	(1)	-20%	27	26	(1)	-4%
Cost of generation	(21)	(19)	2	-11%	(192)	(192)	0	0%
Contracted wholesale sales	47	52	5	11%	398	432	34	9%
<b>Wholesale</b>	<b>29</b>	<b>36</b>	<b>7</b>	<b>24%</b>	<b>233</b>	<b>266</b>	<b>33</b>	<b>14%</b>
Retail	4	6	2	62%	34	36	2	6%
Corporate costs (estimated)	(2)	(2)	0	0%	(15)	(15)	0	0%
<b>Estimated EBITDAF</b>	<b>31</b>	<b>40</b>	<b>9</b>	<b>30%</b>	<b>251</b>	<b>286</b>	<b>35</b>	<b>14%</b>

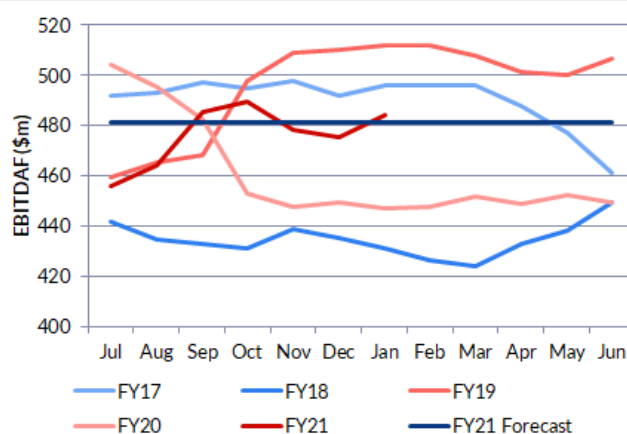
Source: CEN, Forsyth Barr analysis

Figure 6. Historic EBITDAF

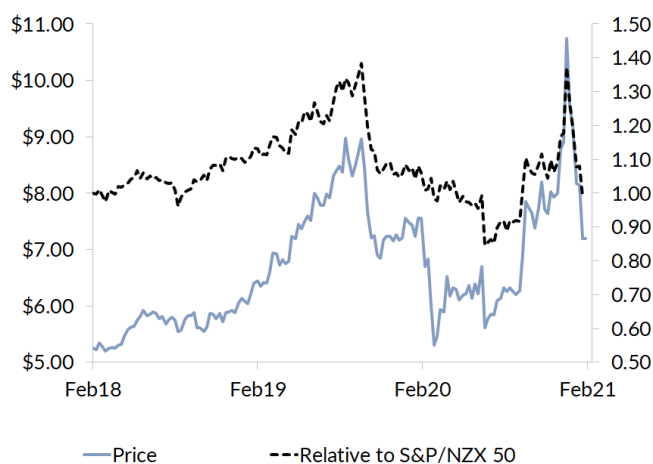


Source: CEN, Forsyth Barr analysis

Figure 7. Rolling 12-month EBITDAF



Source: CEN, Forsyth Barr analysis

**Figure 8. Price performance**


Source: Forsyth Barr analysis

**Figure 9. Substantial shareholders**

Shareholder	Latest Holding
BlackRock Investment Management	14.3%
The Vanguard Group	5.0%

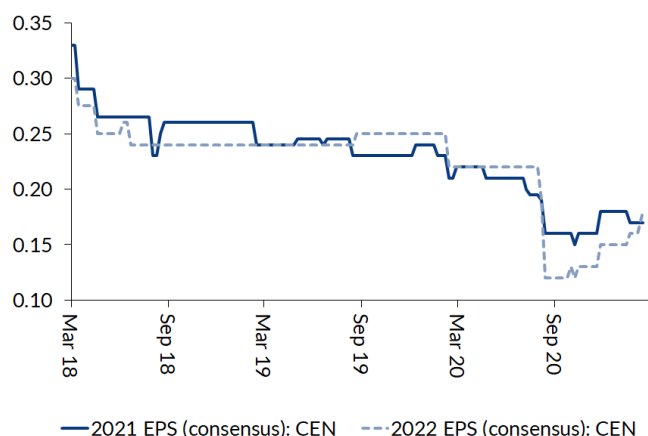
Source: NZX, Forsyth Barr analysis, NOTE: based on SPH notices only

**Figure 10. International valuation comparisons**

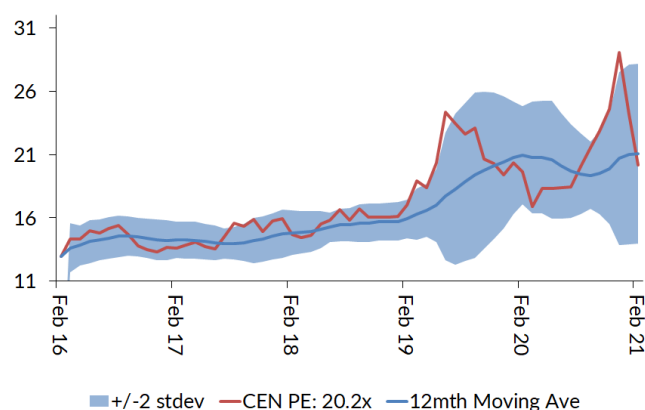
Company	Code	Price	Mkt Cap (m)	PE 2021E	PE 2022E	EV/EBITDA 2021E	EV/EBITDA 2022E	EV/EBIT 2021E	EV/EBIT 2022E	Cash Yld 2022E
(metrics re-weighted to reflect CEN's balance date - June)										
Contact Energy	CEN NZ	NZ\$7.20	NZ\$5,152	20.7x	19.9x	12.9x	12.6x	24.7x	24.0x	5.1%
GENESIS ENERGY *	GNE NZ	NZ\$3.90	NZ\$4,070	21.2x	18.4x	13.0x	12.2x	27.2x	24.7x	4.5%
MERIDIAN ENERGY *	MEL NZ	NZ\$6.53	NZ\$16,734	41.4x	40.7x	25.7x	24.7x	45.2x	42.0x	2.6%
MERCURY *	MCY NZ	NZ\$6.90	NZ\$9,400	32.5x	31.2x	19.6x	18.5x	33.3x	31.0x	2.7%
TRUSTPOWER *	TPW NZ	NZ\$8.99	NZ\$2,814	33.0x	28.6x	17.5x	15.9x	22.8x	20.2x	3.8%
AGL ENERGY	AGL AT	A\$11.16	A\$6,953	12.7x	17.8x	5.7x	6.6x	10.3x	13.8x	5.5%
ORIGIN ENERGY	ORG AT	A\$4.44	A\$7,820	25.8x	16.8x	6.6x	5.9x	25.7x	21.1x	4.8%
Compco Average:				27.8x	25.6x	14.7x	14.0x	27.4x	25.5x	4.0%
CEN Relative:				-26%	-22%	-12%	-10%	-10%	-6%	27%

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 11. Consensus EPS momentum (NZ\$)**


Source: Forsyth Barr analysis

**Figure 12. One year forward PE (x)**


Source: Forsyth Barr analysis

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