FORSYTH BARR

Chorus

NEUTRAL

FY19 — Regulatory Waiting Room

As is typical, there was not much significant new information in Chorus's (CNU) FY19 result. Earnings, including FY20 guidance, were modestly ahead of our expectations on opex savings, with the decline in revenue/EBITDA reflecting CNU continuing to shed share with copper customers transitioning to fibre outside its regions. The key valuation driver for CNU remains the implementation of the new fibre pricing regulatory regime, with the Commerce Commission's publication of its input methodologies draft decision in November the next key step. Maintain NEUTRAL.

What's changed?

- **Earnings:** Lower opex benefiting EBITDA FY20/21E +2%/+3%.
- **Target Price:** DCF-based target price rolled forward and updated for Forbar WACC changes and lower risk-free yield curve to NZ$5.20.

Modest EBITDA and guidance outperformance on cost

Revenue fell -2% yoy as CNU continued to shed share outside its regions. EBITDA, down -3%, was slightly ahead of our expectations on network maintenance and IT operating cost savings. The key new information in the result announcement was FY20 guidance. CNU reiterated its objective to "return to modest EBITDA growth" in FY20. Guidance of NZ$625–645m, supported by "a continued reduction" in opex, was modestly ahead of our pre-result expectation.

Over the capex peak

CNU also reiterated FY19 represented peak capex. It expects debt/EBITDA to top during FY21, and decline thereafter with the strong free cash flow (FCF). CNU stated both ratings agencies are "comfortable" with the profile.

Dividend policy to be unchanged through to FY21

A key investor focus is the significant FCF CNU will generate, and implications for the dividend, once its fibre network is complete in 2022. CNU expects to maintain its current "modest dividend growth" policy until the Commerce Commission (CC) finalises its fibre maximum allowable revenue (MAR) in June 2021. At this time one policy consideration will be the unavailability of imputation credits. Due to depreciation tax shields CNU does not expect to pay tax through the medium-term. On our forecasts CNU will consume its current imputation balance in FY22.

All eyes on the Commerce Commission in November

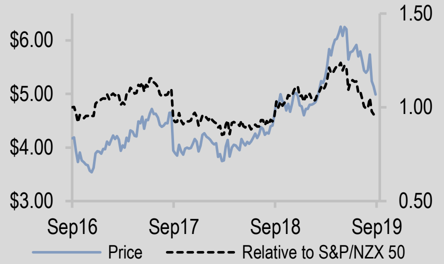
The most material medium-term driver of CNU's valuation remains the to-be-determined regulatory settings and maximum allowable revenue for its fibre network. In May the CC released its "emerging views" in which the low WACC inputs surprised us and the market. The next step in the process is the CC's draft decision on input methodologies scheduled for 29 November. We believe there are areas where CNU could see an improvement from the emerging views; however, CNU's high operating and financial leverage means the valuation sensitivity to the range of possible outcomes remains broad.

Investment View

There is a broad potential range to any long-term assessment of CNU's valuation given its substantial operating and financial leverage, and long-dated UFB network. We view current risks as balanced. NEUTRAL.

NZX Code	CNU
Share price	NZ$4.99
Target price	NZ$5.20
Risk rating	High
Issued shares	439.3m
Market cap	NZ$2,192m
Average daily turnover	493.5k (NZ$2,602k)

Share Price Performance



Financials: June	19A	20E	21E	22E
NPAT* (NZ$m)	53.0	38.3	37.4	13.0
EPS* (NZc)	12.2	8.6	8.2	2.8
EPS growth* (%)	-39.7	-29.4	-4.7	-65.6
DPS (NZc)	23.0	24.0	25.0	26.0
Imputation (%)	100	100	100	86

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	7.2	7.4	7.4	7.9
EV/EBIT	18.8	21.4	21.7	25.4
PE	40.9	n/a	n/a	n/a
Price / NTA	2.8	3.0	3.1	n/a
Cash dividend yield (%)	4.6	4.8	5.0	5.2
Gross dividend yield (%)	6.4	6.7	7.0	6.9

*Historic and forecast numbers based on underlying profits

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Chorus Ltd (CNU) Priced as at 26 Aug 2019: NZ$4.99 June year end

Forsyth Barr valuation			
Valuation methodology			DCF
12-month target price (NZ$)*	**5.20**	**Spot valuations (NZ$)**	
Expected share price return	4.2%	1. DCF	4.84
Net dividend yield	4.8%		
Estimated 12-month return	9.1%		
Key WACC assumptions		**DCF valuation summary (NZ$m)**	
Risk free rate	2.00%	Total firm value	4,462
Equity beta	1.21	(Net debt)/cash	(2,335)
WACC	6.3%	Value of equity	2,127
Terminal growth	1.5%	Shares (m)	439

Profit and Loss Account (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Sales revenue	990.0	970.0	957.5	959.6	915.2
Normalised EBITDA	**653.0**	**636.0**	**634.6**	**641.8**	**606.5**
Depreciation and amortisation	(387.0)	(393.0)	(413.8)	(422.1)	(419.0)
Normalised EBIT	**266.0**	**243.0**	**220.8**	**219.7**	**187.5**
Net interest	(144.0)	(165.0)	(165.9)	(166.1)	(168.8)
Associate income	-	-	-	-	-
Tax	(37.0)	(25.0)	(16.6)	(16.2)	(5.6)
Minority interests	-	-	-	-	-
Normalised NPAT	**85.0**	**53.0**	**38.3**	**37.4**	**13.0**
Abnormals/other	-	-	-	-	-
Reported NPAT	**85.0**	**53.0**	**38.3**	**37.4**	**13.0**
Normalised EPS (cps)	20.2	12.2	8.6	8.2	2.8
DPS (cps)	22.0	23.0	24.0	25.0	26.0

Growth Rates	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Revenue (%)	-4.8	-2.0	-1.3	0.2	-4.6
EBITDA (%)	0.2	-2.6	-0.2	1.1	-5.5
EBIT (%)	-15.0	-8.6	-9.1	-0.5	-14.7
Normalised NPAT (%)	-24.8	-37.6	-27.7	-2.3	-65.2
Normalised EPS (%)	-27.3	-39.7	-29.4	-4.7	-65.6
DPS (%)	4.8	4.5	4.3	4.2	4.0

Cash Flow (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EBITDA	**653.0**	**636.0**	**634.6**	**641.8**	**606.5**
Working capital change	2.0	14.0	(10.1)	(5.8)	(3.4)
Interest & tax paid	(144.0)	(131.0)	(136.0)	(127.3)	(121.7)
Other	(3.0)	(23.0)	-	-	-
Operating cash flow	**508.0**	**496.0**	**488.4**	**508.7**	**481.5**
Capital expenditure	(814.0)	(808.0)	(668.5)	(509.4)	(436.3)
(Acquisitions)/divestments	-	-	-	-	-
Other	140.0	167.0	162.1	109.0	77.1
Funding available/(required)	**(166.0)**	**(145.0)**	**(18.0)**	**108.3**	**122.3**
Dividends paid	(43.0)	(49.0)	(51.8)	(55.4)	(58.5)
Equity raised/(returned)	-	-	-	-	-
Increase/(decrease) in net debt	**209.0**	**194.0**	**69.8**	**(52.9)**	**(63.8)**

Balance Sheet (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Working capital	(216.0)	(220.0)	(209.9)	(204.1)	(200.7)
Fixed assets	4,439.0	4,823.0	5,042.5	5,107.8	5,104.5
Intangibles	182.0	198.0	205.9	198.6	188.5
Other assets	104.0	83.0	83.0	83.0	83.0
Total funds employed	**4,509.0**	**4,884.0**	**5,121.5**	**5,185.4**	**5,175.3**
Net debt/(cash)	1,994.0	1,714.0	1,783.8	1,730.9	1,667.1
Other non current liabilities	1,575.0	1,801.0	1,982.3	2,117.0	2,216.2
Shareholder's funds	1,022.0	979.0	965.4	947.4	902.0
Minority interests	-	-	-	-	-
Total funding sources	**4,591.0**	**4,494.0**	**4,731.5**	**4,795.4**	**4,785.3**

Valuation Ratios	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EV/EBITDA (x)	6.6	7.2	7.4	7.4	7.9
EV/EBIT (x)	16.1	18.8	21.4	21.7	25.4
PE (x)	24.7	40.9	58.0	60.8	>100x
Price/NTA (x)	2.6	2.8	3.0	3.1	3.2
Free cash flow yield (%)	-14.0	-14.2	-8.2	0.0	2.1
Net dividend yield (%)	4.4	4.6	4.8	5.0	5.2
Gross dividend yield (%)	6.1	6.4	6.7	7.0	6.9
Imputation (%)	100	100	100	100	86
Pay-out ratio (%)	109	189	279	305	920

Capital Structure	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Interest cover EBIT (x)	1.8	1.5	1.3	1.3	1.1
Interest cover EBITDA (x)	4.5	3.9	3.8	3.9	3.6
Net debt/ND+E (%)	68.7	71.8	72.8	72.8	73.5
Net debt/EBITDA (x)	3.4	3.9	4.1	4.0	4.1

Key Ratios	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Return on assets (%)	5.4	4.4	3.8	3.8	3.2
Return on equity (%)	8.3	5.4	4.0	4.0	1.4
Return on funds employed (%)	5.1	3.9	3.8	3.8	3.0
EBITDA margin (%)	66.0	65.6	66.3	66.9	66.3
EBIT margin (%)	26.9	25.1	23.1	22.9	20.5
Capex to sales (%)	82.2	83.3	69.8	53.1	47.7
Capex to depreciation (%)	288	267	207	154	131

Operating Performance	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Revenue (NZ$m)					
Copper	581	468	371	294	244
Fibre	276	368	461	548	562
Other	133	134	126	118	110
Total revenue	**990**	**970**	**957**	**960**	**915**
Expenses (NZ$m)					
Labour costs	73	74	74	73	71
Provisioning	6	6	4	3	3
Network maintenance	87	75	71	68	66
Other network costs	34	33	30	30	31
IT costs	54	50	48	49	50
Other	83	96	96	94	88
Total expenses	**337**	**334**	**323**	**318**	**309**
Connections (000s)					
Copper	1,081	840	638	526	424
Fibre	445	610	770	874	966
ARPU (NZ$/month)					
UCLL	30.5	31.0	31.5	31.7	32.3
UBA	11.1	10.9	10.7	10.7	10.9
Fibre (average)	45.5	46.6	48.2	49.5	45.6
Capital expenditure (NZ$m)					
Fibre	620	664	546	393	324
Copper	132	81	61	55	51
Common	58	59	58	59	60
Capitalised interest	4	4	3	2	2
Total capital expenditure	**814**	**808**	**669**	**509**	**436**

* Forsyth Barr target prices reflect valuation rolled forward at cost of equity less the next 12-months dividend

Result analysis

Figure 1. FY19 result analysis

NZ$m	FY18	FY19	% chg	Forbar	% diff	
Revenue						
Copper	581	468	-19.4%	475	-1.4%	Copper connections down -241k/-22%. Customers migrating to CNU and LFC fibre networks, and fixed wireless.
Fibre	276	368	33.3%	360	2.2%	Acceleration in fibre uptake +165k/+37%.
Other	133	134	0.8%	135	-0.9%	Field Services +NZ$4m on lift in network relocation and subdivision activity.
Total revenue	**990**	**970**	**-2.0%**	**970**	**0.0%**	CNU losing market share to local fibre companies and fixed wireless (as expected).
Operating expenses						
Labour	(73)	(74)	1.4%	(74)	0.0%	Year end -2% headcount reduction vs. pcp.
Network maintenance	(87)	(75)	-13.8%	(82)	-8.3%	Faults declining from higher fibre penetration, and improved customer tools reducing truck rolls. Benefited from favourable weather.
Other network costs	(34)	(33)	-2.9%	(37)	-10.0%	
IT costs	(54)	(50)	-7.4%	(53)	-5.5%	New platforms have lowered maintenance and support costs.
Other	(89)	(102)	14.6%	(96)	6.5%	Increased footprint from fibre build (rent, rates, property costs +NZ$6m). Regulatory levies +NZ$3m. Electricity costs +NZ$2m. Regulatory process increasing consultants +NZ$2m.
Total operating expenses	**(337)**	**(334)**	**-0.9%**	**(341)**	**-2.1%**	
EBITDA	**653**	**636**	**-2.6%**	**629**	**1.1%**	FY20 guidance NZ$625-645m.
Depreciation & amortisation	(387)	(393)	1.6%	(398)	-1.2%	Reflects ongoing capex, offset in part by extension of amortisation period of customer retention spend from three to four years.
EBIT	**266**	**243**	**-8.6%**	**231**	**5.1%**	
Interest	(144)	(165)	14.6%	(161)	2.6%	
Net profit before tax	**122**	**78**	**-36.1%**	**70**	**10.6%**	
Tax	(37)	(25)	-32.4%	(21)	17.4%	
Net profit after tax	**85**	**53**	**-37.6%**	**49**	**7.7%**	
Normalised EPS (cps)	20.2	12.2	-39.7%	11.3	7.7%	
Dividend (cps)	22.0	23.0	4.5%	23.0	0.0%	Fully imputed. Dividend reinvestment plan operating, but not underwritten. FY20 guidance NZ24cps.
Capex	810	804	-0.7%	864	-6.9%	Peak capex. FY20 guidance NZ$660-700m.

Source: Company reports, Forsyth Barr analysis

Earnings revisions

Higher operating earnings principally on the back of lower opex. Below the operating line the magnitude of changes by the higher margin of error on depreciation, amortisation, and interest, and low base effect. FY22 is subject to fibre regulatory uncertainty.

Figure 2. Earnings revisions

	FY20E			FY21E			FY22E
NZ$m	**Old**	**New**	**% chg**	**Old**	**New**	**% chg**	**New**
Revenue	957	957	0.0%	958	960	0.2%	915
EBITDA	620	635	2.4%	623	642	3.0%	606
EBIT	199	221	10.7%	194	220	13.4%	187
Adjusted NPAT	16	38	nm	(1)	37	nm	13
Adjusted EPS (cps)	3.7	8.6	nm	-0.2	8.3	nm	2.8
Dividend (cps)	24.0	24.0	0.0%	25.0	25.0	0.0%	26.0

Source: Forsyth Barr analysis

Investment summary

There is a broad potential range to any long-term assessment of CNU's valuation given its substantial operating and financial leverage, and long-dated UFB network. We view current risks as balanced. NEUTRAL.

Business quality

- **Building a high quality fibre network:** CNU is building c.75% of the government-sponsored ultrafast broadband (UFB) fibre network which will allow c.87% of NZers to access fibre-to-the-home by 2022. Uptake of the fibre network has been strong and is now >53% and expanding rapidly, albeit at a cost to CNU shedding its legacy copper customer base.
- **Fibre regulatory regime key value driver:** The most material medium-term impact on CNU's valuation is the implementation of a new regulatory regime for the UFB network which commences 1 January 2022. The next step is the Commerce Commission's draft decision on the input methodologies into this regime to be published in November.

Earnings and cash flow outlook

- **Stabilising financials:** CNU's revenue/EBITDA has been falling as it sheds share with copper customers transitioning to fibre outside its regions, and to fixed wireless broadband. We expect both earnings and debt should start to stabilise with capex having peaked in FY19, fibre revenue surpassing copper in FY20, and CNU to deliver positive free cash flow from FY23 as the UFB capex moderates.

Financial structure

- **Balance sheet:** CNU debt has been rising as the UFB network has been rolled out. CNU expects debt to peak in FY21. Our FY20E net debt/EBITDA of 3.9x/4.2x (includes the present value of interest free government funding) compares to S&P's and Moody's long-term hurdle of 4.75x and 4.2x respectively. We expect rating agencies to remain comforted by the clear path to debt reduction post UFB build.

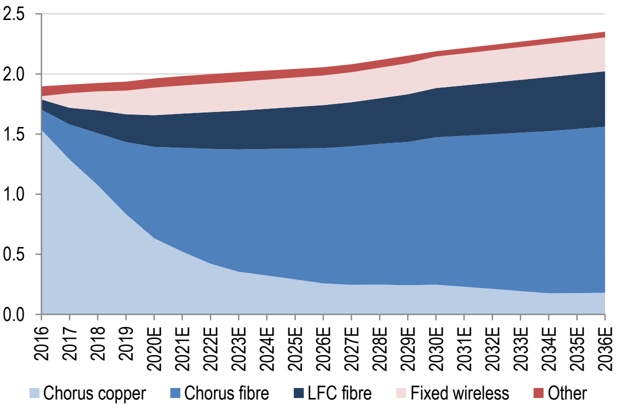
Risks factors

- **Implementation of the new fibre regulatory regime:** CNU is a long-dated business with considerable operating and financial leverage, and therefore significant valuation sensitivity to its allowable regulated fibre revenue.
- **Competition from wireless technologies, and loss of market share to mobile/5G:** We are watchful of improving wireless technology as a long-term risk to CNU. At this time we are not convinced the investment case will support early, broad based adoption of 5G in NZ.

Company description

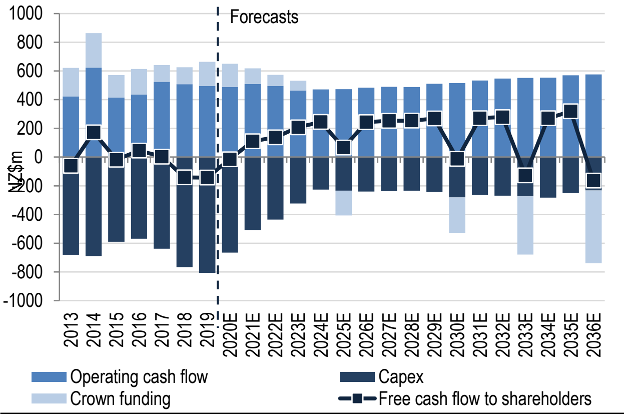
"CNU owns and operates the majority of NZ's fixed-line telecom access network including the legacy copper network and, when completed in 2022, c.75% of NZ's fibre network servicing c.65% of households. It offers open access, largely regulated fixed-line services to retail service providers. CNU is building its fibre network as part of the government-sponsored UFB fibre programme. The UFB programme will cover 87% of the population, with stage 1 (75% of the population) due to complete in 2020 and stage 2 (12%) in 2022. CNU was demerged from Spark (then Telecom NZ) "

Figure 3. NZ fixed line connections (m)



Source: Company reports, Forsyth Barr analysis

Figure 4. Cash flow



Source: Company reports, Forsyth Barr analysis

Figure 5. Substantial Shareholders

Shareholder	Latest Holding
L1 Capital Partners Pty	14.8%
The Vanguard Group	5.4%

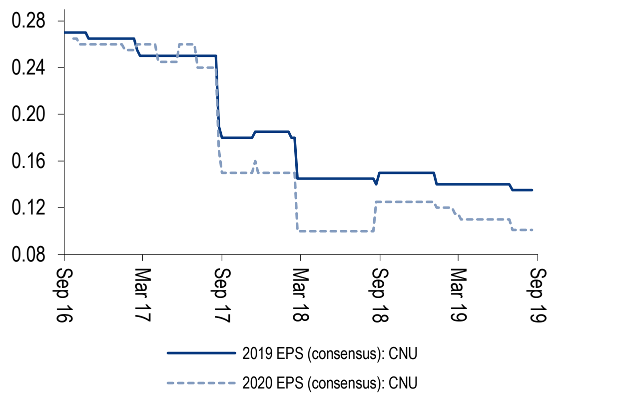
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 6. International Compcos

Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash D/Yld
(metrics re-weighted to reflect CNU's balance date - June)			(m)	2020E	2021E	2020E	2021E	2020E	2021E	2021E
Chorus	**CNU NZ**	**NZ$4.99**	**NZ$2,192**	**>50x**	**>50x**	**7.4x**	**7.3x**	**21.2x**	**21.3x**	**5.0%**
Spark NZ *	SPK NZ	NZ$4.34	NZ$7,960	19.1x	18.9x	8.3x	8.4x	14.8x	14.7x	5.8%
Vector *	VCT NZ	NZ$3.61	NZ$3,594	26.1x	31.3x	10.7x	10.9x	19.5x	20.8x	4.7%
AusNet Services	AST AT	A$1.80	A$6,623	24.3x	23.8x	12.1x	11.6x	19.7x	18.6x	5.9%
Spark Infrastructure Group	SKI AT	A$2.36	A$3,970	34.8x	43.8x	14.8x	15.5x	16.2x	18.7x	6.1%
Telstra Corp	TLS AT	A$3.74	A$44,481	17.6x	19.1x	6.9x	7.2x	13.7x	15.2x	4.3%
TPG Telecom	TPM AT	A$6.60	A$6,124	21.9x	27.1x	9.9x	10.5x	17.2x	21.6x	0.9%
Vocus Group	VOC AT	A$3.18	A$1,973	18.8x	16.2x	8.2x	7.7x	15.4x	14.2x	0.6%
BT Group PLC	BT/A LN	£1.59	£15,707	6.5x	6.3x	3.5x	3.5x	7.3x	7.2x	8.9%
NetLink NBN Trust	NETLINK SP	S$0.89	S$3,468	40.0x	37.9x	15.2x	14.5x	40.5x	36.7x	5.9%
			Compco Average:	**23.2x**	**24.9x**	**10.0x**	**10.0x**	**18.3x**	**18.6x**	**4.8%**
EV = Current Market Cap + Actual Net Debt			**CNU Relative:**	**n/a**	**n/a**	**-26%**	**-27%**	**+16%**	**+14%**	**+5%**

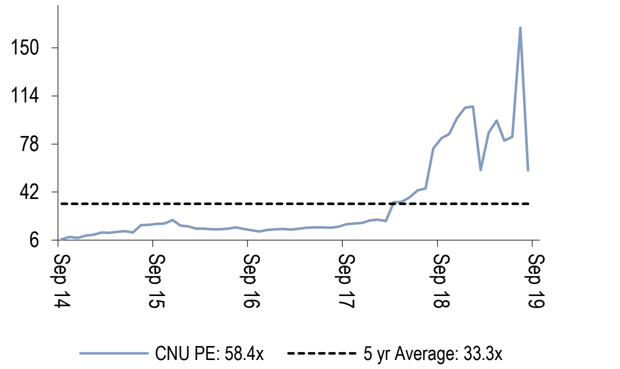
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (CNU) companies fiscal year end

Figure 7. Consensus EPS Momentum



Source: Forsyth Barr analysis, Bloomberg

Figure 8. 12 Month Forward PE



Source: Forsyth Barr analysis