

# Chorus

OUTPERFORM

## An Improved Regulatory Picture

The regulatory picture for Chorus (CNU) improved with the Commerce Commission's (CC) draft decision on the "input methodologies" which feed into the regulatory determination for CNU's new ultrafast fibre broadband (UFB) network. From a CNU perspective, the draft decision is positive progress relative to the CC's emerging views published in May. Whilst there remains an inherent and material uncertainty in the ultimate outcome from the UFB regulatory process, which will not be finalised until 2Q 2021, our base case scenario remains materially above what is currently implied by the share price. Maintain OUTPERFORM.

### What's changed?

- **Target Price:** Lifted to NZ\$6.40.

### Positive changes vs. CC's "emerging views"

The principal changes in the CC's draft decision vs. the emerging views that benefit CNU are:

- **Asset beta:** Increased to 0.49, from 0.46 (but below our assumed 0.51).
- **Market risk premium:** Increased to 7.5%, from 7.0%.
- **Tax losses:** The opening regulatory asset base (RAB) is to include the present value of pre-2022 losses. Tax losses are now able to be included in those loss calculations. Previously the CC's view was to exclude tax losses based on the assumption that they had already been used to offset profits in other parts of the company.
- **Crown financing:** The benefit of the Crown financing is to be deducted in the determination of the "maximum allowable revenue" (MAR) CNU is able to earn on the UFB. The CC now proposes to calculate this benefit at the (lower) cost of debt vs. previously at WACC.
- **Asset stranding ("type II") risks:** A +10bp margin on WACC to compensate for asset stranding risk.

With the exception of asset beta, we had factored no other improvements into our base case scenario. Incorporating the above changes increases our DCF valuation by +NZ65cps or +11%. We expect CNU will continue to challenge some assumptions, most notably asset beta, but believe achieving changes will be more difficult in the final stage of the input methodologies process.

### Comfortable with uncertainty; remain attracted to long-term cash flow

We continue to acknowledge the inherently high margin of error in any CNU valuation given the possible range of regulatory outcomes, the long-dated nature of the UFB asset, and the company's high operating and financial leverage. We remain comfortable with this uncertainty given: (1) our base case scenario valuation is significantly above the share price, and (2) the cost of capital we used to derive this valuation is significantly above what the market is currently applying to defensive assets. The CC's current schedule is to finalise the input methodologies in June 2020, and the UFB's MAR in 2Q 2021.

### Investment View

We remain attracted to CNU's fundamental value underpinned by the considerable long-term free cash flow we expect the company to generate once its fibre network is complete in 2022. OUTPERFORM.

NZX Code	CNU
Share price	NZ\$5.55
Target price	NZ\$6.40
Risk rating	High
Issued shares	439.3m
Market cap	NZ\$2,438m
Average daily turnover	480.5k (NZ\$2,579k)

### Share Price Performance



Financials: June	19A	20E	21E	22E
NPAT* (NZ\$m)	53.0	34.1	24.0	32.4
EPS* (NZc)	12.2	7.7	5.3	7.1
EPS growth* (%)	-39.7	-36.9	-30.8	34.1
DPS (NZc)	23.0	24.0	25.0	26.0
Imputation (%)	100	100	100	69

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	7.6	7.9	8.1	7.9
EV/EBIT	19.8	23.1	24.9	23.2
PE	45.5	n/a	n/a	n/a
Price / NTA	3.1	3.3	3.6	n/a
Cash dividend yield (%)	4.1	4.3	4.5	4.7
Gross dividend yield (%)	5.8	6.0	6.3	5.9

\*Historic and forecast numbers based on underlying profits

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Chorus Ltd (CNU)		Priced as at 19 Nov 2019: NZ\$5.55					June year end					
<b>Forsyth Barr valuation</b>							<b>Valuation Ratios</b>	<b>2018A</b>	<b>2019A</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>
Valuation methodology		DCF					EV/EBITDA (x)	6.9	7.6	7.9	8.1	7.9
12-month target price (NZ\$)*		<b>6.40</b>	<b>Spot valuations (NZ\$)</b>				EV/EBIT (x)	17.0	19.8	23.1	24.9	23.2
Expected share price return	15.3%	1. DCF			6.42	PE (x)	27.4	45.5	72.1	>100x	77.7	
Net dividend yield	4.4%						Price/NTA (x)	2.8	3.1	3.3	3.6	3.8
Estimated 12-month return	19.7%						Free cash flow yield (%)	-12.6	-12.8	-7.5	-0.5	3.0
<b>Key WACC assumptions</b>		<b>DCF valuation summary (NZ\$m)</b>					Net dividend yield (%)	4.0	4.1	4.3	4.5	4.7
Risk free rate	2.00%	Total firm value			5,156	Gross dividend yield (%)	5.5	5.8	6.0	6.3	5.9	
Equity beta	1.16	(Net debt)/cash			(2,335)	Imputation (%)	100	100	100	100	69	
WACC	6.1%	Value of equity			2,821	Pay-out ratio (%)	109	189	312	469	364	
Terminal growth	1.5%	Shares (m)			439	<b>Capital Structure</b>		<b>2018A</b>	<b>2019A</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>
<b>Profit and Loss Account (NZ\$m)</b>		<b>2018A</b>	<b>2019A</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>	Interest cover EBIT (x)	1.8	1.5	1.3	1.2	1.3
Sales revenue	990.0	970.0	951.7	941.0	943.1	Interest cover EBITDA (x)	4.5	3.9	3.8	3.7	3.7	
<b>Normalised EBITDA</b>	<b>653.0</b>	<b>636.0</b>	<b>628.9</b>	<b>623.4</b>	<b>634.8</b>	Net debt/ND+E (%)	68.7	71.8	73.3	74.2	74.7	
Depreciation and amortisation	(387.0)	(393.0)	(413.6)	(421.5)	(417.8)	Net debt/EBITDA (x)	3.4	3.9	4.1	4.1	4.0	
<b>Normalised EBIT</b>	<b>266.0</b>	<b>243.0</b>	<b>215.2</b>	<b>201.9</b>	<b>217.0</b>	<b>Key Ratios</b>		<b>2018A</b>	<b>2019A</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>
Net interest	(144.0)	(165.0)	(166.4)	(167.6)	(170.6)	Return on assets (%)	5.4	4.4	3.8	3.5	3.8	
Associate income	-	-	-	-	-	Return on equity (%)	8.3	5.4	3.6	2.7	3.8	
Tax	(37.0)	(25.0)	(14.8)	(10.4)	(14.0)	Return on funds employed (%)	5.1	3.9	3.7	3.3	3.8	
Minority interests	-	-	-	-	-	EBITDA margin (%)	66.0	65.6	66.1	66.3	67.3	
<b>Normalised NPAT</b>	<b>85.0</b>	<b>53.0</b>	<b>34.1</b>	<b>24.0</b>	<b>32.4</b>	EBIT margin (%)	26.9	25.1	22.6	21.5	23.0	
Abnormals/other	-	-	-	-	-	Capex to sales (%)	82.2	83.3	69.9	53.5	45.3	
<b>Reported NPAT</b>	<b>85.0</b>	<b>53.0</b>	<b>34.1</b>	<b>24.0</b>	<b>32.4</b>	Capex to depreciation (%)	288	267	206	152	129	
Normalised EPS (cps)	20.2	12.2	7.7	5.3	7.1	<b>Operating Performance</b>		<b>2018A</b>	<b>2019A</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>
DPS (cps)	22.0	23.0	24.0	25.0	26.0	<b>Revenue (NZ\$m)</b>						
<b>Growth Rates</b>		<b>2018A</b>	<b>2019A</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>	Copper	581	468	361	267	202
Revenue (%)	-4.8	-2.0	-1.9	-1.1	0.2	Fibre	276	368	465	556	632	
EBITDA (%)	0.2	-2.6	-1.1	-0.9	1.8	Other	133	134	126	118	110	
EBIT (%)	-15.0	-8.6	-11.4	-6.2	7.5	<b>Total revenue</b>	<b>990</b>	<b>970</b>	<b>952</b>	<b>941</b>	<b>943</b>	
Normalised NPAT (%)	-24.8	-37.6	-35.7	-29.7	35.1	<b>Expenses (NZ\$m)</b>						
Normalised EPS (%)	-27.3	-39.7	-36.9	-30.8	34.1	Labour costs	73	74	74	73	71	
DPS (%)	4.8	4.5	4.3	4.2	4.0	Provisioning	6	6	4	3	3	
<b>Cash Flow (NZ\$m)</b>		<b>2018A</b>	<b>2019A</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>	Network maintenance	87	75	71	68	66
EBITDA	653.0	636.0	628.9	623.4	634.8	Other network costs	34	33	30	30	31	
Working capital change	2.0	14.0	(9.4)	(4.2)	(10.3)	IT costs	54	50	48	49	50	
Interest & tax paid	(144.0)	(131.0)	(136.4)	(128.8)	(123.5)	Other	83	96	96	94	88	
Other	(3.0)	(23.0)	-	-	-	<b>Total expenses</b>	<b>337</b>	<b>334</b>	<b>323</b>	<b>318</b>	<b>308</b>	
<b>Operating cash flow</b>	<b>508.0</b>	<b>496.0</b>	<b>483.1</b>	<b>490.5</b>	<b>501.0</b>	<b>Connections (000s)</b>						
Capital expenditure	(814.0)	(808.0)	(665.7)	(503.3)	(427.1)	Copper	1,081	840	627	478	339	
(Acquisitions)/divestments	-	-	-	-	-	Fibre	445	610	782	885	978	
Other	140.0	167.0	162.1	109.0	77.1	<b>ARPU (NZ\$/month)</b>						
<b>Funding available/(required)</b>	<b>(166.0)</b>	<b>(145.0)</b>	<b>(20.5)</b>	<b>96.1</b>	<b>151.1</b>	UCLL	30.5	31.0	31.5	31.7	32.3	
Dividends paid	(43.0)	(49.0)	(66.1)	(71.3)	(75.0)	UBA	11.1	10.9	10.7	10.7	10.9	
Equity raised/(returned)	-	-	-	-	-	Fibre (average)	45.5	46.6	48.2	49.5	51.2	
<b>Increase/(decrease) in net debt</b>	<b>209.0</b>	<b>194.0</b>	<b>86.6</b>	<b>(24.8)</b>	<b>(76.1)</b>	<b>Capital expenditure (NZ\$m)</b>						
<b>Balance Sheet (NZ\$m)</b>		<b>2018A</b>	<b>2019A</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>	Fibre	620	664	546	393	324
Working capital	(216.0)	(220.0)	(210.6)	(206.5)	(196.2)	Copper	132	81	59	49	41	
Fixed assets	4,439.0	4,823.0	5,040.0	5,100.3	5,089.5	Common	58	59	58	59	60	
Intangibles	182.0	198.0	205.7	197.9	187.4	Capitalised interest	4	4	3	2	2	
Other assets	104.0	83.0	83.0	83.0	83.0	<b>Total capital expenditure</b>	<b>814</b>	<b>808</b>	<b>666</b>	<b>503</b>	<b>427</b>	
<b>Total funds employed</b>	<b>4,509.0</b>	<b>4,884.0</b>	<b>5,118.1</b>	<b>5,174.8</b>	<b>5,163.7</b>	<b>Net debt/(cash)</b>						
Net debt/(cash)	1,994.0	1,714.0	1,800.6	1,775.8	1,699.7	Other non current liabilities	1,575.0	1,801.0	1,980.5	2,109.3	2,217.0	
Other non current liabilities	1,575.0	1,801.0	1,980.5	2,109.3	2,217.0	Shareholder's funds	1,022.0	979.0	947.0	899.6	857.0	
Shareholder's funds	1,022.0	979.0	947.0	899.6	857.0	Minority interests	-	-	-	-	-	
Minority interests	-	-	-	-	-	<b>Total funding sources</b>	<b>4,591.0</b>	<b>4,494.0</b>	<b>4,728.1</b>	<b>4,784.8</b>	<b>4,773.7</b>	

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

# Investment summary

We are attracted to CNU's fundamental value underpinned by the considerable long-term free cash flow we expect the company to generate once its ultra-fast broadband (UFB) fibre network is complete in 2022. We believe an FCF yield of >10% from FY24E onward could facilitate a significant lift in CNU's dividend. **OUTPERFORM.**

## 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 >55% 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 steps are submissions on the Commerce Commission's (CC) draft input methodologies (IMs) due by 17 December, and the CC's final IM decision scheduled to be published on 2 June.

## 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.

### 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)

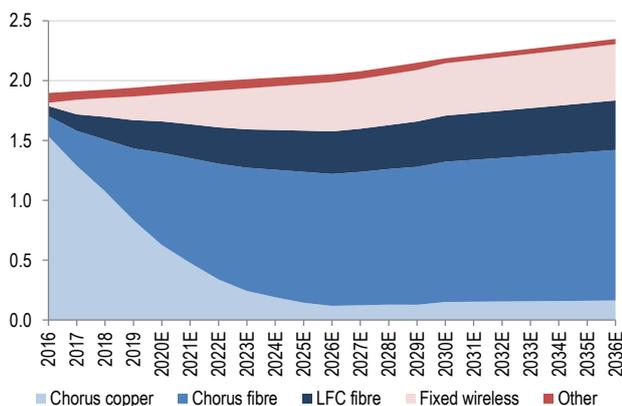
### Financial structure

- **Balance sheet:** CNU debt has been rising as the UFB network has been rolled out. CNU expects debt to peak in FY21. Our FY20/21E net debt/EBITDA of 4.1/4.1x (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

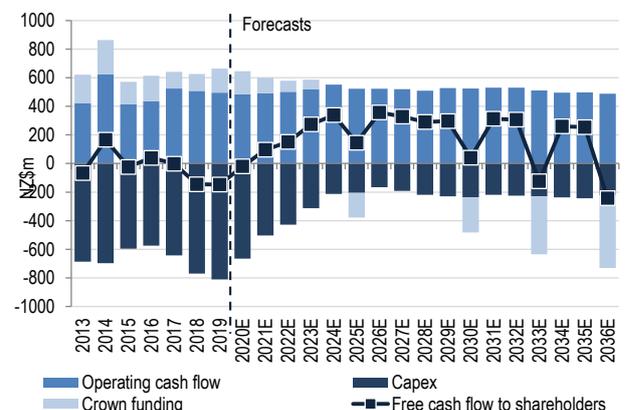
- **Implementation of the new fibre regulatory regime:** CNU is a long-dated business with considerable operating and financial leverage, and therefore significant valuation sensitivity to its allowable regulated fibre revenue.
- **Competition from wireless technologies, and loss of market share to mobile/5G:** 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.

Figure 1. NZ fixed line connections (m)



Source: Company reports, Forsyth Barr analysis

Figure 2. Cash flow



Source: Company reports, Forsyth Barr analysis

**Figure 3. Substantial Shareholders**

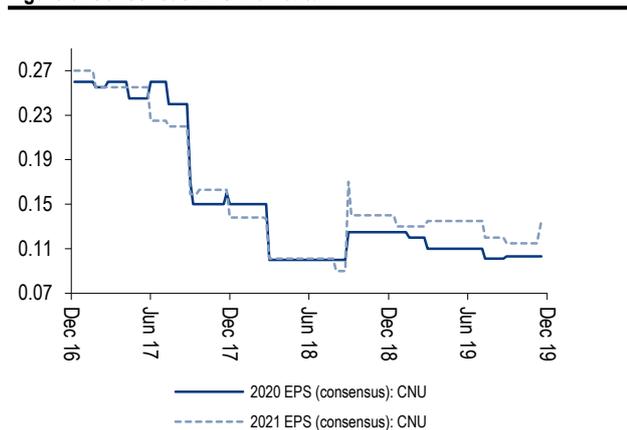
Shareholder	Latest Holding
L1 Capital Partners Pty	14.8%
The Vanguard Group	5.4%
Commonwealth Bank of Australia	5.0%

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

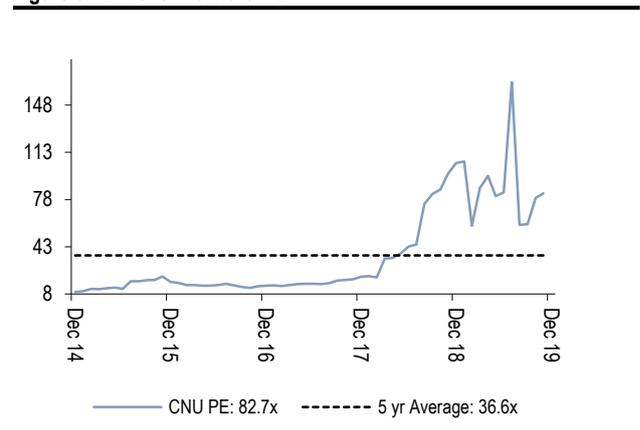
**Figure 4. International Compco's**

Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash D/Yld
<i>(metrics re-weighted to reflect CNU's balance date - June)</i>										
			(m)	2020E	2021E	2020E	2021E	2020E	2021E	2021E
<b>Chorus</b>	<b>CNU NZ</b>	<b>NZ\$5.55</b>	<b>NZ\$2,438</b>	<b>&gt;50x</b>	<b>&gt;50x</b>	<b>7.8x</b>	<b>7.9x</b>	<b>22.9x</b>	<b>24.4x</b>	<b>4.5%</b>
Spark NZ *	SPK NZ	NZ\$4.51	NZ\$8,285	19.9x	19.7x	8.6x	8.7x	15.3x	15.2x	5.5%
Vector *	VCT NZ	NZ\$3.56	NZ\$3,544	25.7x	30.8x	10.7x	10.8x	19.3x	20.7x	4.8%
AusNet Services	AST AT	A\$1.76	A\$6,494	24.1x	24.1x	12.6x	12.2x	20.8x	20.0x	6.0%
Spark Infrastructure Group	SKI AT	A\$2.05	A\$3,483	27.6x	38.9x	13.2x	16.6x	14.3x	17.5x	6.9%
Telstra Corp	TLS AT	A\$3.55	A\$42,221	17.1x	17.6x	6.7x	6.9x	13.7x	14.4x	4.5%
TPG Telecom	TPM AT	A\$6.63	A\$6,151	24.5x	27.1x	10.4x	10.4x	18.2x	19.9x	0.9%
Vocus Group	VOC AT	A\$3.43	A\$2,129	20.9x	18.5x	8.7x	8.1x	16.9x	15.2x	0.3%
BT Group PLC	BT/A LN	£1.93	£19,027	8.1x	7.8x	4.9x	4.9x	10.2x	10.0x	7.0%
NetLink NBN Trust	NETLINK SP	S\$0.93	S\$3,624	41.4x	38.4x	15.5x	15.0x	41.2x	37.9x	5.6%
<b>Compco Average:</b>				<b>23.3x</b>	<b>24.8x</b>	<b>10.1x</b>	<b>10.4x</b>	<b>18.9x</b>	<b>19.0x</b>	<b>4.6%</b>
<b>EV = Current Market Cap + Actual Net Debt</b>				<b>CNU Relative:</b>	<b>n/a</b>	<b>n/a</b>	<b>-23%</b>	<b>-24%</b>	<b>+21%</b>	<b>+29%</b>

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

**Figure 5. Consensus EPS Momentum**


Source: Forsyth Barr analysis, Bloomberg

**Figure 6. 12 Month Forward PE**


Source: Forsyth Barr analysis

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