FORSYTH BARR

NEW ZEALAND EQUITY RESEARCH | TELECOMMUNICATIONS | INFRASTRUCTURE
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Chorus
1H20 Result — Cash Prize In Sight

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OUTPERFORM

Chorus's (CNU) 1H20 result and upgraded guidance were ahead of our expectations; however, we suspect it was the indication of a material, medium-term step up in dividend that triggered the positive market reaction. CNU inferred that from FY22 it will pay out a high portion of its free cash flow (FCF) as dividends. We estimate from FY24 (when the "communal" part of the fibre network is complete) CNU will generate FCF >NZ70cps (albeit with nil tax paid). This attractive FCF profile continues to underpin our positive investment view; maintain OUTPERFORM.

NZX Code	CNU
Share price	NZ$6.73
Target price	NZ$6.90
Risk rating	High
Issued shares	439.3m
Market cap	NZ$2,956m
Avg daily turnover	455.4k (NZ$2,565k)

Financials: Jun/	19A	20E	21E	22E
NPAT* (NZ$m)	53.0	55.9	51.0	51.3
EPS* (NZc)	12.2	12.6	11.5	11.5
EPS growth* (%)	-39.7	3.7	-9.4	0.5
DPS (NZc)	23.0	24.0	25.0	30.0
Imputation (%)	100	100	100	43

*Based on normalised profits

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	8.4	8.4	8.5	8.4
EV/EBIT	21.9	21.6	22.7	22.3
PE	n/a	n/a	n/a	n/a
Price / NTA	3.8	4.0	4.3	4.8
Cash div yld (%)	3.4	3.6	3.7	4.5
Gross div yld (%)	4.7	5.0	5.2	5.2

Cost savings coming earlier than we expected

CNU's revenue, down -1%, has now largely stabilised with the growing fibre base now bigger than the declining copper one. For us, the surprise in 1H20 was the sharp reduction in operating costs, including a -6% decline in staff numbers, lower maintenance costs (helped by both the transition to a new fibre network, and less adverse weather events), and a reduction in the Telco Development (regulatory) Levy. Lower opex underpin both (1) a lift in FY20 EBITDA guidance to NZ$640–655m (from NZ$625–645m), and (2) upgrades to our medium-term forecasts FY20/21/22E EBITDA +4%/+6%/+5%. We expect opex reductions to be an ongoing feature as CNU's focus shifts from network build to network operations.

Free cash flow and increased dividend one step closer

In our opinion, the positive share price reaction to CNU's result is a response to (1) the company's statement it expects to generate "substantial FCF" once the fibre network build is complete in 2022, and (2) its indication it will distribute a high portion of this FCF to shareholders. We estimate from FY24 (when the "communal" part of the fibre network is complete) CNU will generate FCF >NZ70cps (with nil tax paid), and assume a long-term sustainable dividend of c.NZ50cps (partly imputed long-term). CNU reiterated its current imputation credit balance will be fully utilised during FY22, and for a period thereafter dividends will not be imputed (consistent with our forecasts). CNU may consider other capital management options and has c.NZ$225m of available subscribed capital to buy back stock tax efficiently.

Regulatory settings remain a key driver

The most material medium-term driver of CNU's valuation remains the to-be-finalised regulatory settings and maximum allowable revenue (MAR) for its fibre network. In November, the regulatory picture improved with the Commerce Commission's (CC) draft decision on the "input methodologies" which will feed into determining CNU's MAR. The potential range of outcomes has narrowed, but (1) there still remains an element of uncertainty, with (2) the valuation implications magnified by CNU's high operating and financial leverage. The CC's current schedule is to finalise the input methodologies on 2 June 2020, and the MAR in 2Q 2021

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Chorus Ltd (CNU)

Priced as at 24 Feb 2020 (NZ$)	**6.73**

12-month target price (NZ$)*	**6.90**
Expected share price return	2.5%
Net dividend yield	3.7%
Estimated 12-month return	6.2%

Spot valuations (NZ$)	
1. DCF	6.45

Key WACC assumptions	
Risk free rate	2.00%
Equity beta	1.16
WACC	6.1%
Terminal growth	2.0%

DCF valuation summary (NZ$m)	
Total firm value	5,437
(Net debt)/cash	(2,335)
Less: Capitalised operating leases	(268)
Value of equity	2,834

Profit and Loss Account (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Sales revenue	990	970	956	953	950
Normalised EBITDA	**653**	**636**	**655**	**661**	**667**
Depreciation and amortisation	(387)	(393)	(399)	(413)	(415)
Normalised EBIT	**266**	**243**	**256**	**247**	**252**
Net interest	(144)	(165)	(176)	(174)	(178)
Associate income	0	0	0	0	0
Tax	(37)	(25)	(24)	(22)	(22)
Minority interests	0	0	0	0	0
Normalised NPAT	**85**	**53**	**56**	**51**	**51**
Abnormals/other	0	0	0	0	0
Reported NPAT	**85**	**53**	**56**	**51**	**51**
Normalised EPS (cps)	20.2	12.2	12.6	11.5	11.5
DPS (cps)	22.0	23.0	24.0	25.0	30.0

Valuation Ratios	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EV/EBITDA (x)	7.7	8.4	8.4	8.5	8.4
EV/EBIT (x)	19.0	21.9	21.6	22.7	22.3
PE (x)	33.3	55.2	53.2	58.7	58.4
Price/NTA (x)	3.4	3.8	4.0	4.3	4.8
Free cash flow yield (%)	-10.4	-11.2	-8.4	-1.5	1.5
Net dividend yield (%)	3.3	3.4	3.6	3.7	4.5
Gross dividend yield (%)	4.5	4.7	5.0	5.2	5.2

Capital Structure	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Interest cover EBIT (x)	1.8	1.5	1.5	1.4	1.4
Interest cover EBITDA (x)	4.5	3.9	3.7	3.8	3.7
Net debt/ND+E (%)	68.7	71.8	73.4	75.0	76.6
Net debt/EBITDA (x)	3.4	3.9	4.1	4.1	4.1

Growth Rates	**2018A**	**2019A**	**2020A**	**2021A**	**2022A**
Revenue (%)	-4.8	-2.0	-1.4	-0.3	-0.3
EBITDA (%)	0.2	-2.6	3.0	0.9	0.9
EBIT (%)	-15.0	-8.6	5.2	-3.2	1.8
Normalised NPAT (%)	-24.8	-37.6	5.5	-8.8	0.5
Normalised EPS (%)	-27.3	-39.7	3.7	-9.4	0.5
Ordinary DPS (%)	4.8	4.5	4.3	4.2	20.0

Key Ratios	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Return on assets (%)	5.3	4.3	4.3	4.1	4.2
Return on equity (%)	8.3	5.4	5.8	5.6	6.2
Return on funds employed (%)	5.5	3.9	4.2	3.9	4.1
EBITDA margin (%)	66.0	65.6	68.5	69.3	70.1
EBIT margin (%)	26.9	25.1	26.7	26.0	26.5
Capex to sales (%)	82.2	83.3	73.5	56.5	48.3
Capex to depreciation (%)	288	267	229	170	143
Imputation (%)	100	100	100	100	43
Pay-out ratio (%)	109	189	190	218	260

Cash Flow (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EBITDA	**653**	**636**	**655**	**661**	**667**
Working capital change	2	14	(33)	(9)	(9)
Interest & tax paid	(144)	(151)	(167)	(158)	(154)
Other	(3)	(23)	0	0	0
Operating cash flow	**508**	**476**	**455**	**494**	**503**
Capital expenditure	(814)	(808)	(703)	(539)	(459)
(Acquisitions)/divestments	0	0	0	0	0
Other	125	146	160	107	75
Funding available/(required)	**(181)**	**(186)**	**(87)**	**62**	**119**
Dividends paid	(43)	(49)	(73)	(109)	(122)
Equity raised/(returned)	0	0	0	0	0
(Increase)/decrease in net debt	**(224)**	**(235)**	**(160)**	**(47)**	**(4)**

Operating Performance	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Revenue (NZ$m)					
Copper	581	468	363	275	204
Fibre	276	368	469	561	637
Other	133	134	125	117	110
Total revenue	**990**	**970**	**956**	**953**	**950**
Expenses (NZ$m)					
Labour costs	73	74	77	73	70
Network maintenance	87	75	69	66	64
Other network costs	34	33	24	24	25
IT costs	54	50	44	45	46
Other	89	102	88	85	79
Total expenses	**337**	**334**	**302**	**293**	**284**
Connections (000s)					
Copper	1,081	840	634	487	347
Fibre	445	610	775	878	970
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	47.5	48.5	49.8	51.5

Balance Sheet (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Working capital	(216)	(220)	(187)	(178)	(169)
Fixed assets	4,213	4,598	4,871	4,982	5,017
Intangibles	182	198	214	212	205
Right of use asset	226	225	228	232	235
Other assets	186	184	184	184	184
Total funds employed	**4,591**	**4,985**	**5,310**	**5,432**	**5,471**
Net debt/(cash)	1,757	1,959	2,098	2,123	2,104
Lease liability	237	246	260	274	288
Other liabilities	1,575	1,801	1,990	2,130	2,246
Shareholder's funds	1,022	979	962	904	833
Minority interests	0	0	0	0	0
Total funding sources	**4,591**	**4,985**	**5,310**	**5,432**	**5,471**

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

Figure 1. 1H20 financial summary

NZ$m	1H19	1H20	% chg	Forbar	% diff
Revenue					
Copper	247	194	-21.5%	193	0.3%
Fibre	173	223	28.9%	218	2.5%
Other	69	66	-4.3%	66	0.6%
Total revenue	**489**	**483**	**-1.2%**	**477**	**1.3%**
Operating expenses					
Labour	(37)	(39)	5.4%	(37)	5.2%
Network maintenance	(38)	(34)	-10.5%	(36)	-4.6%
Other network costs	(18)	(12)	-33.3%	(15)	-19.1%
IT costs	(26)	(23)	-11.5%	(24)	-4.2%
Other	(52)	(43)	-17.3%	(50)	-13.9%
Total operating expenses	**(171)**	**(151)**	**-11.7%**	**(161)**	**-6.5%**
EBITDA	**318**	**332**	**4.4%**	**315**	**5.3%**
Depreciation & amortisation	(196)	(198)	1.0%	(206)	-3.7%
EBIT	**122**	**134**	**9.8%**	**110**	**22.3%**
Interest	(79)	(88)	11.4%	(82)	7.8%
Net profit before tax	**43**	**46**	**7.0%**	**28**	**64.3%**
Tax	(13)	(15)	15.4%	(8)	77.4%
Net profit after tax	**30**	**31**	**3.3%**	**20**	**58.7%**
Normalised profit	**30**	**31**	**3.3%**	**20**	**58.7%**
Normalised EPS (cps)	7.2	7.2	-0.4%	4.5	58.7%
Dividend (cps)	9.5	10.0	5.3%	10.0	0.0%

Source: Company reports, Forsyth Barr analysis

Figure 2. Earnings revisions

		FY20E			FY21E			FY22E	
NZ$m	**Old**	**New**	**% chg**	**Old**	**New**	**% chg**	**Old**	**New**	**% chg**
Revenue	952	956	0.5%	941	953	1.3%	943	950	0.8%
EBITDA	629	655	4.1%	623	661	6.0%	635	667	5.0%
EBIT	216	256	18.2%	202	247	22.4%	216	252	16.5%
Adjusted NPAT	35	56	62.0%	23	51	126.0%	30	51	73.4%
Adjusted EPS (cps)	7.8	12.6	62.3%	5.0	11.5	128.5%	6.5	11.5	76.7%
Dividend (cps)	24.0	24.0	0.0%	25.0	25.0	0.0%	26.0	30.0	15.4%

Source: Forsyth Barr analysis

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 a 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 step is the Commerce Commission's (CC) publication of its final Input Methodologies decision scheduled for 2 June.

Earnings and cashflow 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 FY22 as the UFB capex moderates.

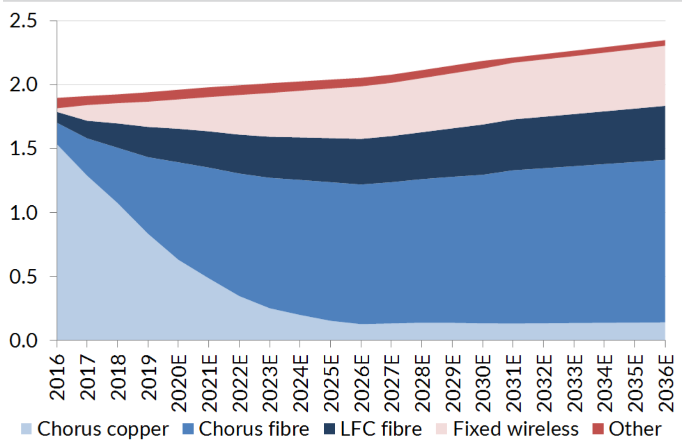
Financial structure

- **Balance sheet:** CNU debt has been rising as the UFB network has been rolled out. CNU expects debt to peak in FY21. Our 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.

Risk factors

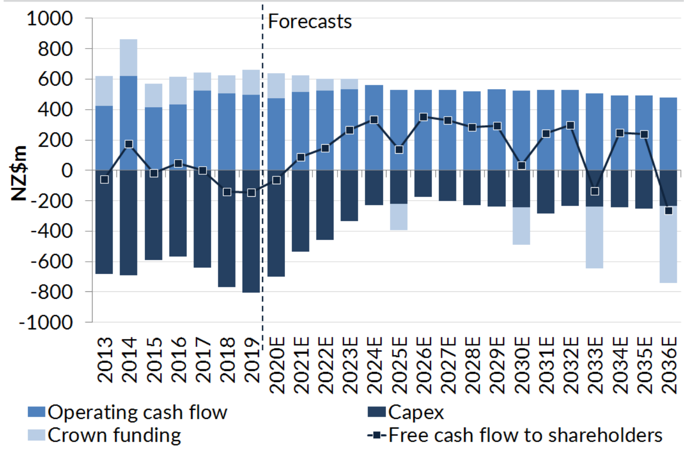
- **Implementation of the new fibre regulatory regime:** CNU is a long-dated business with considerable operating and financial leverage, and therefore significant valuation sensitivity to its allowable regulated fibre revenue.
- **Competition from wireless technologies, and loss of market share to mobile/5G:** 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 3. NZ fixed line connections (m)



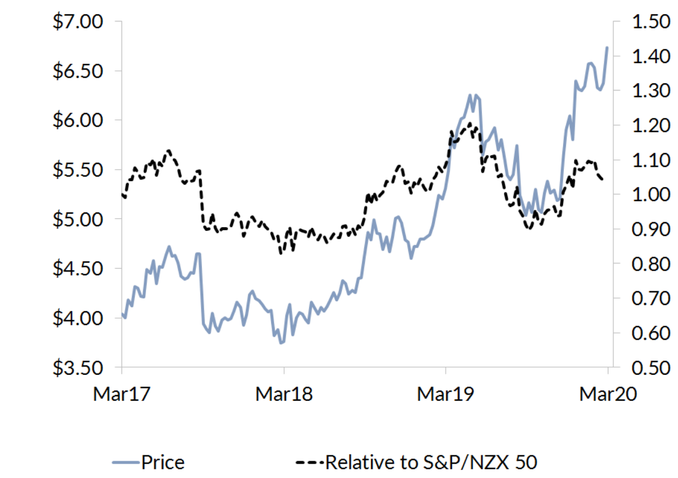
Source: Company reports, Forsyth Barr analysis

Figure 4. Cash flow



Source: Company reports, Forsyth Barr analysis

Figure 5. Price performance



Source: Forsyth Barr analysis

Figure 6. Substantial shareholders

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

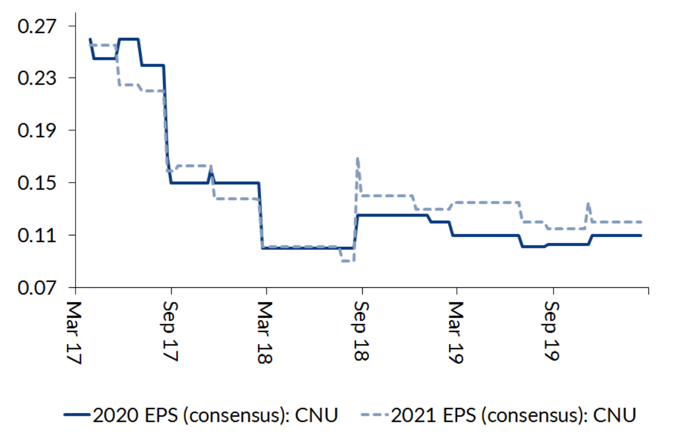
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 7. International valuation comparisons

Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash Yld
(metrics re-weighted to reflect CNU's balance date - June)			(m)	2020E	2021E	2020E	2021E	2020E	2021E	2021E
Chorus	**CNU NZ**	**NZ$6.73**	**NZ$2,956**	**>50x**	**>50x**	**8.3x**	**8.2x**	**21.3x**	**22.0x**	**3.7%**
Spark NZ *	SPK NZ	NZ$4.77	NZ$8,754	21.7x	21.0x	9.2x	9.0x	16.1x	15.7x	5.2%
Vector *	VCT NZ	NZ$3.35	NZ$3,335	24.6x	29.2x	10.4x	10.5x	18.9x	20.0x	5.1%
AUSNET SERVICES	AST AT	A$1.72	A$6,392	23.2x	23.4x	12.5x	12.2x	20.7x	20.0x	6.1%
SPARK INFRASTRUCTURE GROUP	SKI AT	A$2.12	A$3,593	28.5x	39.9x	10.7x	11.9x	14.2x	16.9x	6.5%
TELSTRA CORP	TLS AT	A$3.71	A$44,065	18.4x	18.7x	7.1x	7.4x	15.4x	15.7x	4.3%
TPG TELECOM	TPM AT	A$7.94	A$7,367	30.5x	29.5x	12.0x	10.7x	21.2x	18.2x	0.7%
VOCUS GROUP	VOC AT	A$3.59	A$2,228	21.1x	19.6x	9.3x	8.8x	17.0x	16.4x	0.1%
BT GROUP PLC	BT/A LN	£1.56	£15,444	6.7x	6.7x	4.4x	4.4x	9.5x	9.5x	7.2%
NETLINK NBN TRUST	NETLINK SP	S$1.03	S$4,014	45.8x	42.5x	17.0x	16.4x	45.3x	42.0x	5.1%
			Compco Average:	**24.5x**	**25.6x**	**10.3x**	**10.1x**	**19.8x**	**19.4x**	**4.5%**
EV = Current Market Cap + Actual Net Debt			**CNU Relative:**	**n/a**	**n/a**	**-19%**	**-19%**	**8%**	**14%**	**-17%**

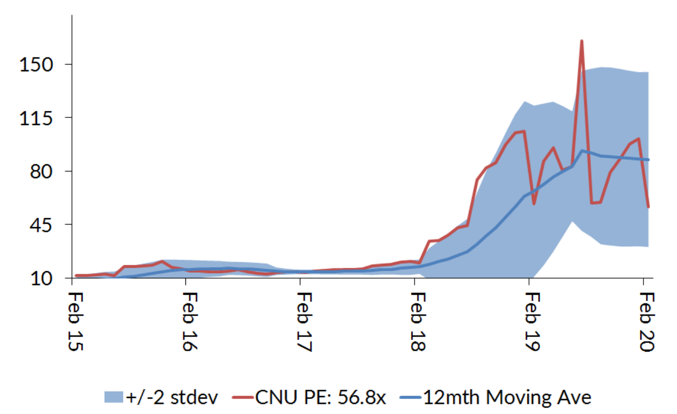
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (CNU) companies fiscal year end

Figure 8. Consensus EPS momentum (NZ$)



Source: Forsyth Barr analysis

Figure 9. One year forward PE (x)



Source: Forsyth Barr analysis

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