

# Chorus

## FY20 – Appeal in an Income Scarce World

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### OUTPERFORM

There was little significant new information in Chorus's (CNU) FY20 result. Key questions remain unchanged: (1) what revenue (and therefore free cash flow [FCF]) will CNU generate under the to-be-finalised fibre regulatory regime? and (2) how will the market value CNU's FCF and dividend yield once that is determined? We estimate that from FY24 CNU will generate FCF of c.NZ70cps, which could support a sustainable dividend in the range NZ50–60cps. Despite CNU's substantial share price re-rating over the past 12 months, we see continued appeal in its (relative) value in an income-scare world. Maintain OUTPERFORM.

NZX Code	CNU	Financials: Jun/	20A	21E	22E	23E	Valuation (x)	20A	21E	22E	23E
Share price	NZ\$8.21	NPAT* (NZ\$m)	52.0	38.6	43.0	37.4	EV/EBITDA	9.6	9.8	9.7	9.8
Target price	NZ\$8.80	EPS* (NZc)	11.8	8.7	9.7	8.4	EV/EBIT	25.3	27.6	27.2	27.3
Risk rating	High	EPS growth* (%)	-3.5	-26.3	11.2	-13.3	PE	69.7	94.6	85.0	98.1
Issued shares	444.0m	DPS (NZc)	24.0	25.0	35.0	45.0	Price / NTA	5.1	5.8	6.5	8.2
Market cap	NZ\$3,643m	Imputation (%)	100	100	69	18	Cash div yld (%)	2.9	3.0	4.3	5.5
Avg daily turnover	388.9k (NZ\$2,495k)	*Based on normalised profits					Gross div yld (%)	4.1	4.2	5.4	5.9

### Operating earnings broadly stable

CNU's revenue, down -1%, and EBITDA, up +2%, have now broadly stabilised with the growing fibre base now bigger than the declining copper one. Cost savings insulated a (relatively modest) c.NZ\$12m EBITDA impact from COVID-19. CNU expects operating earnings to remain largely flat in FY21, with EBITDA guidance of NZ\$640–660m (cf. FY20 NZ\$648m) including a NZ\$10m allowance for COVID-19 and related economic impacts.

### Market remains focussed on free cash flow prize

The market continues to look forward and consider the potential significant FCF CNU will generate, and implications for the dividend, once its fibre network is complete in 2022. CNU explicitly outlined (1) it will transition to a FCF-based dividend policy from FY22, including (2) an expectation of NZ\$200m pa in maintenance capex, sharply down from current fibre network rollout levels. We estimate from FY24 (when the "communal" part of the fibre network is complete) CNU will generate FCF of c.NZ70cps (albeit with partial tax paid due to depreciation tax shields), and assume a long-term sustainable dividend of c.NZ50–60cps (partly imputed). CNU has stated it may consider other capital management options and has c.NZ\$225m of available subscribed capital to buy back stock tax efficiently.

### Step-by-step, edging toward regulatory clarity

The most material medium-term driver of CNU's valuation remains the to-be-finalised regulatory settings and maximum allowable revenue (MAR) to be earned from its fibre network. There still remains uncertainty around the outcome, with the valuation implications magnified by CNU's high operating and financial leverage. The next key steps are the CC's publication of final input methodology decisions on 3 October and 3 November, with final clarity on the MAR still around a year away, scheduled for 2H of CY21.

**Chorus Ltd (CNU)**

Priced as at 24 Aug 2020 (NZ\$)						8.21					
<b>12-month target price (NZ\$)*</b>						8.80	<b>Spot valuations (NZ\$)</b>				
Expected share price return						7.2%	1. DCF				
Net dividend yield						3.2%					
Estimated 12-month return						10.4%					
<b>Key WACC assumptions</b>						<b>DCF valuation summary (NZ\$m)</b>					
Risk free rate						1.30%	Total firm value				
Equity beta						1.21	(Net debt)/cash				
WACC						5.3%	Less: Capitalised operating leases				
Terminal growth						1.8%	Value of equity				
<b>Profit and Loss Account (NZ\$m)</b>	<b>2019A</b>	<b>2020A</b>	<b>2021E</b>	<b>2022E</b>	<b>2023E</b>	<b>Valuation Ratios</b>					
Sales revenue	970	959	957	956	944	EV/EBITDA (x)	2019A	2020A	2021E	2022E	2023E
<b>Normalised EBITDA</b>	<b>636</b>	<b>648</b>	<b>653</b>	<b>667</b>	<b>661</b>	EV/EBIT (x)	9.4	9.6	9.8	9.7	9.8
Depreciation and amortisation	(393)	(402)	(421)	(429)	(423)	PE (x)	24.7	25.3	27.6	27.3	27.3
<b>Normalised EBIT</b>	<b>243</b>	<b>246</b>	<b>232</b>	<b>238</b>	<b>237</b>	Price/NTA (x)	67.3	69.7	94.6	85.1	98.1
Net interest	(165)	(173)	(178)	(177)	(185)	Free cash flow yield (%)	4.6	5.1	5.8	6.5	8.3
Associate income	0	0	0	0	0	Net dividend yield (%)	-9.1	-5.8	-4.3	1.1	3.9
Tax	(25)	(21)	(16)	(17)	(15)	Gross dividend yield (%)	2.8	2.9	3.0	4.3	5.5
Minority interests	0	0	0	0	0	<b>Capital Structure</b>					
<b>Normalised NPAT</b>	<b>53</b>	<b>52</b>	<b>39</b>	<b>43</b>	<b>37</b>	Interest cover EBIT (x)	2019A	2020A	2021E	2022E	2023E
Abnormals/other	0	0	0	0	0	Interest cover EBITDA (x)	1.5	1.4	1.3	1.3	1.3
<b>Reported NPAT</b>	<b>53</b>	<b>52</b>	<b>39</b>	<b>43</b>	<b>37</b>	Net debt/ND+E (%)	3.9	3.7	3.7	3.8	3.6
Normalised EPS (cps)	12.2	11.8	8.7	9.7	8.4	Net debt/EBITDA (x)	71.8	74.3	76.6	78.1	80.9
DPS (cps)	23.0	24.0	25.0	35.0	45.0	<b>Key Ratios</b>					
<b>Growth Rates</b>						<b>2019A</b>	<b>2020A</b>	<b>2021E</b>	<b>2022E</b>	<b>2023E</b>	
Revenue (%)	-2.0	-1.1	-0.2	-0.1	-1.3	Return on assets (%)	2019A	2020A	2021E	2022E	2023E
EBITDA (%)	-2.6	1.9	0.8	2.1	-1.0	Return on equity (%)	4.3	4.4	4.0	4.1	4.1
EBIT (%)	-8.6	1.2	-5.6	2.4	-0.1	Return on funds employed (%)	5.4	5.6	4.4	5.4	5.6
Normalised NPAT (%)	-37.6	-1.9	-25.8	11.6	-13.1	EBITDA margin (%)	3.9	4.1	3.5	3.6	3.7
Normalised EPS (%)	-39.7	-3.5	-26.3	11.2	-13.3	EBIT margin (%)	65.6	67.6	68.3	69.8	70.0
Ordinary DPS (%)	4.5	4.3	4.2	40.0	28.6	Capex to sales (%)	25.1	25.7	24.3	24.9	25.1
<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>636</b>	<b>648</b>	<b>653</b>	<b>667</b>	<b>661</b>	Capex to depreciation (%)	2019A	2020A	2021E	2022E	2023E
Working capital change	4	(17)	(6)	(13)	(3)	Imputation (%)	267	209	194	137	103
Interest & tax paid	(151)	(158)	(163)	(155)	(171)	Pay-out ratio (%)	100	100	100	69	18
Other	(13)	(20)	0	0	0	<b>Operating Performance</b>					
<b>Operating cash flow</b>	<b>476</b>	<b>453</b>	<b>484</b>	<b>499</b>	<b>486</b>	<b>2019A</b>	<b>2020A</b>	<b>2021E</b>	<b>2022E</b>	<b>2023E</b>	
Capital expenditure	(808)	(666)	(642)	(460)	(344)	<b>Revenue (NZ\$m)</b>					
(Acquisitions)/divestments	0	0	0	0	0	Copper	468	369	277	199	144
Other	146	139	103	106	43	Fibre	368	466	561	642	689
<b>Funding available/(required)</b>	<b>(186)</b>	<b>(74)</b>	<b>(55)</b>	<b>145</b>	<b>185</b>	Other	134	124	119	116	112
Dividends paid	(49)	(76)	(98)	(118)	(165)	<b>Total revenue</b>	<b>970</b>	<b>959</b>	<b>957</b>	<b>956</b>	<b>944</b>
Equity raised/(returned)	0	0	0	0	0	<b>Expenses (NZ\$m)</b>					
<b>(Increase)/decrease in net debt</b>	<b>(235)</b>	<b>(150)</b>	<b>(153)</b>	<b>26</b>	<b>19</b>	Labour costs	2019A	2020A	2021E	2022E	2023E
<b>Balance Sheet (NZ\$m)</b>						<b>2019A</b>	<b>2020A</b>	<b>2021E</b>	<b>2022E</b>	<b>2023E</b>	
Working capital	(220)	(144)	(138)	(124)	(121)	Network maintenance	74	80	77	75	73
Fixed assets	4,598	4,824	5,013	5,029	4,943	Other network costs	75	64	61	60	59
Intangibles	198	215	233	230	220	IT costs	33	29	30	25	26
Right of use asset	225	228	227	226	225	Other	50	47	48	49	50
Other assets	184	235	235	235	235	<b>Total expenses</b>	<b>334</b>	<b>311</b>	<b>304</b>	<b>289</b>	<b>284</b>
<b>Total funds employed</b>	<b>4,985</b>	<b>5,358</b>	<b>5,570</b>	<b>5,597</b>	<b>5,502</b>	<b>Connections (000s)</b>					
Net debt/(cash)	1,959	2,325	2,456	2,407	2,364	Copper	2019A	2020A	2021E	2022E	2023E
Lease liability	246	257	268	279	290	Copper	840	664	459	329	233
Other liabilities	1,801	1,849	1,978	2,118	2,184	Fibre	610	751	900	990	1,055
Shareholder's funds	979	927	868	792	664	<b>ARPU (NZ\$/month)</b>					
Minority interests	0	0	0	0	0	UCLL	2019A	2020A	2021E	2022E	2023E
<b>Total funding sources</b>	<b>4,985</b>	<b>5,358</b>	<b>5,570</b>	<b>5,597</b>	<b>5,502</b>	UCLL	31.0	31.5	31.7	32.3	33.0
						UBA	10.9	10.7	10.7	10.9	11.1
						Fibre (average)	47.5	48.9	50.0	51.0	51.1

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

**Figure 1. FY20 result summary**

NZ\$m	FY19	FY20	% chg	Forbar	% diff
<b>Revenue</b>					
Copper	468	369	-21.2%	371	-0.4%
Fibre	368	466	26.6%	461	1.0%
Other	134	124	-7.5%	125	-0.7%
<b>Total revenue</b>	<b>970</b>	<b>959</b>	<b>-1.1%</b>	<b>957</b>	<b>0.2%</b>
<b>Operating expenses</b>					
Labour	(74)	(80)	8.1%	(77)	3.9%
Network maintenance	(75)	(64)	-14.7%	(69)	-7.2%
Other network costs	(33)	(29)	-12.1%	(24)	22.6%
IT costs	(50)	(47)	-6.0%	(44)	6.8%
Other	(102)	(91)	-10.8%	(90)	0.9%
<b>Total operating expenses</b>	<b>(334)</b>	<b>(311)</b>	<b>-6.9%</b>	<b>(304)</b>	<b>2.4%</b>
<b>EBITDA</b>	<b>636</b>	<b>648</b>	<b>1.9%</b>	<b>653</b>	<b>-0.7%</b>
<b>Depreciation &amp; amortisation</b>	<b>(393)</b>	<b>(402)</b>	<b>2.3%</b>	<b>(398)</b>	<b>0.9%</b>
EBIT	243	246	1.2%	254	-3.3%
Interest	(165)	(173)	4.8%	(175)	-1.0%
<b>Net profit before tax</b>	<b>78</b>	<b>73</b>	<b>-6.4%</b>	<b>80</b>	<b>-8.4%</b>
Tax	(25)	(21)	-16.0%	(24)	-12.7%
<b>Net profit after tax</b>	<b>53</b>	<b>52</b>	<b>-1.9%</b>	<b>56</b>	<b>-6.5%</b>
<b>Normalised profit</b>	<b>53</b>	<b>52</b>	<b>-1.9%</b>	<b>56</b>	<b>-6.5%</b>
Normalised EPS (cps)	12.2	11.8	-3.5%	12.6	-6.4%
Dividend (cps)	23.0	24.0	4.3%	24.0	0.0%
Capex	804	663	-17.5%	649	2.1%
<b>Connections</b>					
Copper	840	664	-21.0%		
Fibre	610	751	23.1%		
<b>Total</b>	<b>1,450</b>	<b>1,415</b>	<b>-2.4%</b>		

Source: Company reports, Forsyth Barr analysis

**Figure 2. Earnings revisions**

NZ\$m	FY21E			FY22E			FY23E
	Old	New	% chg	Old	New	% chg	New
Revenue	949	957	0.9%	944	956	1.3%	944
EBITDA	654	653	-0.1%	658	667	1.4%	661
EBIT	241	232	-3.8%	240	238	-0.7%	237
Adjusted NPAT	48	39	-19.1%	42	43	1.4%	37
Adjusted EPS (cps)	10.7	8.7	-19.0%	9.5	9.7	1.1%	8.4
Dividend (cps)	25.0	25.0	0.0%	30.0	35.0	16.7%	45.0

Source: Forsyth Barr analysis

## Investment Summary

We are attracted to CNU's fundamental value underpinned by the considerable long-term free cash flow (FCF) we expect the company to generate once its ultra-fast broadband (UFB) fibre network is complete in 2022. We estimate from FY24 (when the "communal" part of the fibre network is complete) CNU will generate FCF of c.NZ70cps, which could support a long-term sustainable dividend of c.NZ50–60cps (partly imputed). **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 c.60% 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 significant step is a final input methodologies decision paper scheduled to be published on 13 October.

### 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.

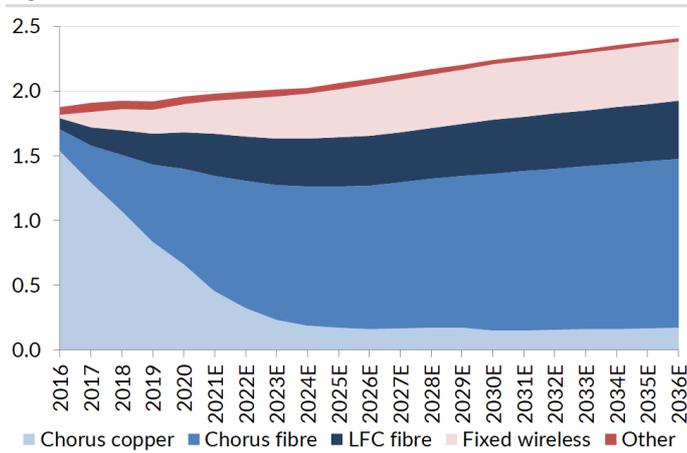
### Financial structure

- **Balance sheet:** CNU debt has been rising as the UFB network has been rolled out. CNU expects debt to peak in FY21. Our FY21E net debt/EBITDA of 4.3x (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

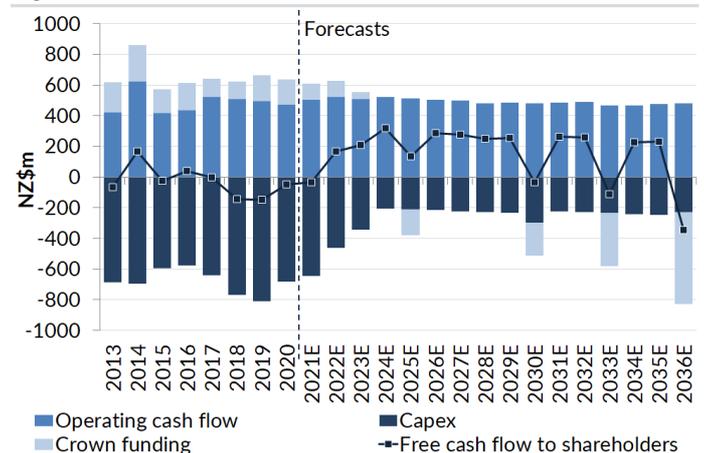
- **Implementation of the new fibre regulatory regime:** CNU is a long-dated business with considerable operating and financial leverage, and therefore significant valuation sensitivity to its allowable regulated fibre revenue.
- **Competition from wireless technologies, and loss of market share to mobile/5G:** We are watchful of improving wireless technology as a long-term risk to CNU. At this time we believe fixed services over wireless technology will be a niche, rather than mass-market product.

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	11.0%
Commonwealth Bank of Australia	6.5%
The Vanguard Group	5.4%

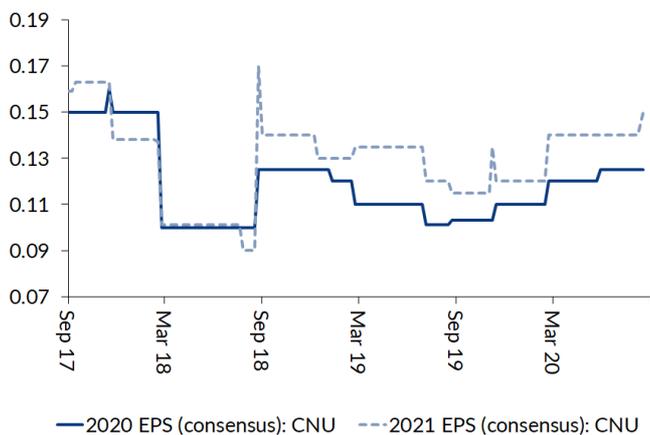
Source: NZX, Forsyth Barr analysis, NOTE: based on SPH notices only

**Figure 7. International valuation comparisons**

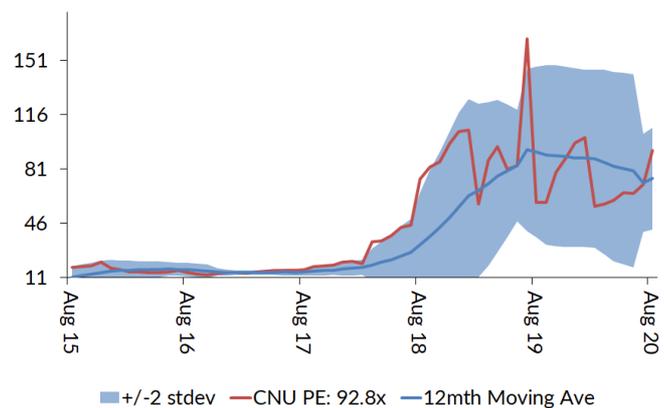
Company	Code	Price	Mkt Cap (m)	PE		EV/EBITDA		EV/EBIT		Cash Yld
				2021E	2022E	2021E	2022E	2021E	2022E	
(metrics re-weighted to reflect CNU's balance date - June)										
Chorus	CNU NZ	NZ\$8.21	NZ\$3,643	>50x	>50x	9.7x	9.5x	27.2x	26.6x	4.3%
SPARK NZ*	SPK NZ	NZ\$4.93	NZ\$9,057	22.5x	21.7x	9.4x	9.3x	16.5x	16.2x	5.1%
VECTOR*	VCT NZ	NZ\$4.30	NZ\$4,281	31.6x	35.2x	11.8x	11.9x	21.5x	22.4x	3.8%
AUSNET SERVICES	AST AT	A\$1.82	A\$6,812	25.4x	27.1x	13.6x	13.6x	22.8x	23.1x	5.2%
SPARK INFRASTRUCTURE GROUP	SKI AT	A\$2.19	A\$3,762	41.8x	>50x	6.1x	6.2x	16.6x	19.7x	5.7%
TELSTRA CORP	TLS AT	A\$3.07	A\$36,512	23.6x	22.1x	7.2x	7.5x	18.0x	18.5x	4.7%
TPG CORP	TPM AT	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
VOCUS GROUP	VOC AT	A\$3.48	A\$2,160	19.8x	18.2x	8.5x	8.1x	16.5x	15.4x	1.4%
BT GROUP PLC	BT/ALN	£1.02	£10,096	5.5x	5.4x	3.9x	3.9x	9.4x	9.2x	7.5%
NETLINK NBN TRUST	NETLINK SP	\$0.97	\$3,780	40.0x	38.4x	15.6x	15.3x	40.3x	39.0x	5.2%
<b>Compcop Average:</b>				<b>26.3x</b>	<b>24.0x</b>	<b>9.5x</b>	<b>9.5x</b>	<b>20.2x</b>	<b>20.4x</b>	<b>4.8%</b>
<b>CNU Relative:</b>				<b>n/a</b>	<b>n/a</b>	<b>2%</b>	<b>0%</b>	<b>35%</b>	<b>30%</b>	<b>-11%</b>

EV = Current Market Cap + Actual Net Debt

Source: \*Forsyth Barr analysis, Bloomberg Consensus, Compcop 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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