Electricity Sector

Meridian the Shining Beacon — 1H20 Result Preview

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The only electricity generator/retailer we expect will lift earnings in 1H20 is Meridian Energy (MEL), with sector EBITDAF slipping -6% to $1.11b, only the second time in the past decade sector earnings have fallen. The weaker sector result is in part due to asset sales and in part a very strong pcp. Contact Energy (CEN) is, as usual, the first company to report on Monday, 10 February.

Figure 1. Summary 1H19 forecasts

Company Reporting date	CEN Mon 10 Feb	GNE Fri 21 Feb	MCY Tue 25 Feb	MEL Wed 26 Feb
1H20 EBITDAF forecast ($m)	220	167	254	466
1H19 Actual ($m)	291	196	302	389
% Chg	-24%	-15%	-16%	20%
1H20 EPS Forecast (cps)	8.9	1.9	6.3	7.5
1H19 Actual (cps)	14.9	4.3	8.4	5.6
% Chg	-41%	-54%	-25%	33%
1H20 Dividend forecast (incl Special) (cps)	16.0	8.60	6.3	8.34
1H19 Actual dividend (incl Special) (cps)	16.0	8.45	6.2	8.14
% Chg	0.0%	1.8%	1.6%	2.5%

Source: Company reports, Forsyth Barr analysis

Asset sales, strong pcp and increased fuel costs impact 1H20 earnings

We are forecasting sector EBITDAF to fall -6% (-$71m) in 1H20 vs. the pcp. Whilst 1H20 wholesale electricity prices have been above average and hydro generation reasonable, 1H20 is lapping a very strong period. In addition, Mercury (MCY) and CEN have sold assets contributing ~$31m of the fall in earnings, Genesis Energy's (GNE) generation fuel costs have increased +$21m and CEN and MEL are paying $10m to Transpower to start lower South Island transmission work.

Modest dividend growth expected despite weaker earnings

We are forecasting sector dividends to lift +1.6%, with MEL providing the biggest increase as it is the only generator/retailer expected to deliver earnings growth. Whilst sector earnings have tracked backwards in 1H20, we do not expect anything other than the businesses at least maintaining their dividend. There is sector confidence in a stronger 2H20. MEL had been planning to update the market on its capital management programme, but given the NZAS uncertainty, we expect it to delay that update.

NZAS, UTS claim and timing of further new build the main sector issues

Last year the sector issues were the Electricity Price Review (EPR) and elevated wholesale electricity prices due to the Pohokura gas outage. Whilst the EPR has been completed, there are ongoing questions about the wholesale electricity market, particularly in light of the undesirable trading situation (UTS) claim surrounding CEN and MEL spilling more water than was arguably needed.

Investment View

We continue to like the long-term outlook for the sector and maintain our view that NZAS will not be closing. Our preferred stocks are CEN and GNE (OUTPERFORM), with MCY, MEL and Trustpower (TPW) rated NEUTRAL.

Big result for MEL, the others less so

Our 1H20 forecasts indicate MEL is set to break another record and will be the only generator/retailer to grow EBITDAF in 1H20. It has, once again, benefitted from above average hydrology and above average wholesale electricity prices. We are forecasting that all of the other generator/retailer profits will fall backwards, with CEN having the dubious honour of leading the charge.

However, whilst the -6% fall in sector EBITDAF is only the second time in the last decade sector 1H earnings have fallen, there are several reasons for that.

1) 1H19 earnings were a record. 1H20 EBITDAF is forecast to be +3.8% higher than 1H18.

2) Asset sales. We estimate that CEN earnings will be -$17m lower vs. the pcp due to the sale of its Ahuroa gas storage facility and LPG business. MCY sold its Metrix metering business in 2H19, with an estimated -$14m EBITDAF impact.

3) MEL and CEN have paid Transpower $10m to advance their transmission work in the lower South Island.

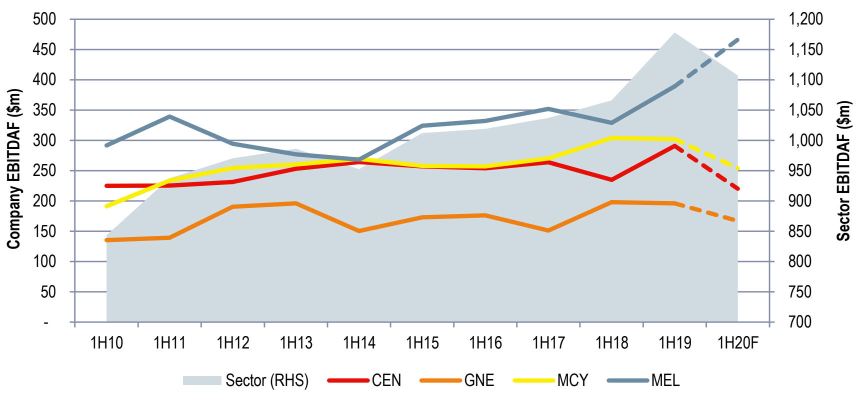
4) GNE has seen a big increase in fuel costs — both gas and coal. We estimate the increased fuel prices will impact 1H20 -$21m (based on fuel consumed for 1H20 generation). In addition, our Kupe earnings forecast is -$9m lower due to the Kupe maintenance outage.

Figure 2. Summary 1H20 EBITDAF forecast change vs. pcp and commentary

	EBITDAF Chg		
	$m	**%**	**Key drivers**
CEN	-71	-24%	Sale of LPG and Ahuroa gas storage, tougher hydro conditions in 1Q20 and gas constraints all combined to lower earnings
GNE	-29	-15%	A planned Kupe outage and big increases in thermal generation fuel costs are the main driver of lower earnings
MCY	-48	-16%	Sale of Metrix metering business in 2H19 and lapping a very strong hydro period has lowered EBITDAF
MEL	+77	+20%	Another stunning period for MEL, with above average hydro generation and a strong retail performance
Sector	**-71**	**-6%**	Only the second year in the past decade with negative sector earnings growth, due mainly to asset sales and strong pcp results

Source: Forsyth Barr analysis

Figure 3. Forecast company and sector EBITDAF



Source: Company reports, Forsyth Barr analysis

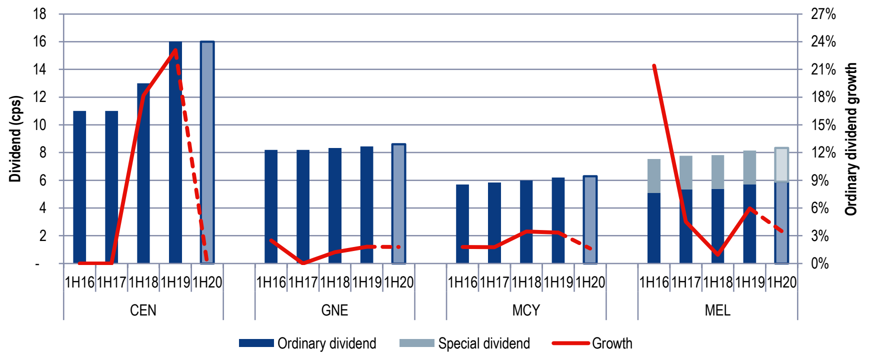
Modest dividend growth expected despite lack of earnings growth

We are forecasting an increase of +1.6% in sector dividends, with MEL providing the biggest increase. Given it is the only generator/retailer growing earnings, this is of little surprise.

CEN's 1H20 dividend is likely to be flat given it has guided to a flat FY20 39cps dividend. GNE and MCY dividend increases are expected to be modest, also in line with dividend guidance/policy.

Whilst earnings have not been great relative to the pcp, the generator/retailer dividend policies are designed to look through short-term earnings noise. It would, therefore, be a major surprise if there was any dividend cut.

Figure 4. Interim dividend forecast



Source: Company reports, Forsyth Barr analysis

Sector talking points

These are the topics we expect to get airtime during the reporting season:

- **NZAS closure risk**: Ever since Rio Tinto dropped its bombshell that it was undertaking a strategic review of NZAS, this has been the number one sector (and investor) issue. Whilst it will be hard for the generator/retailers to say much, we expect messages that even if NZAS did close (which in our view is unlikely), the impact on the sector would be temporary.
- **UTS claim**: In December an undesirable trading situation (UTS) claim was brought against CEN and MEL for pricing water too high at a time the lakes were spilling. Expect CEN and MEL to defend their position and highlight that the immediate downside risk is limited. MCY and GNE may have a different view point.
- **New build**: One year ago we were talking about the possibility of new build taking place. We now have two wind farms under construction. CEN and MEL are also working towards new projects but as yet have not committed to anything, and in light of the NZAS uncertainty their commentary on progress will be interesting.
- **Gas market and the impact of 2H20 infrastructure outages**: The Pohokura outage in September 2018 sparked material change in wholesale electricity prices which has been sustained. A talking point for 2H20 is the impact of outages to:
  - **Pohokura gas production**
  - **HCDC maintenance work**
  - **Ahuroa gas storage upgrade**
  - **Kupe well work**

  MEL and CEN will be negatively affected by the HVDC outage, with GNE impacted the most by Pohokura and Kupe outages. MCY is best placed to take advantage of wholesale market volatility as none of its generation plant is impacted and it has deliberately stored more water ahead of 2H20.

Sector FY20 outlook

There is reasonable divergence of current FY20 EBITDAF forecasts amongst analysts, with GNE being the exception. Company earnings revisions could be material, with MEL (up) and CEN (down) the two with the greatest potential for change.

Figure 5. FY20 EBITDAF market forecasts

	CEN $m	GNE $m	MCY $m	MEL $m
Forsyth Barr	**444**	**362**	**511**	**863**
Market low	444	362	484	766
Consensus (median)	**472**	**369**	**511**	**807**
Market high	505	377	523	863
Range ($m)	61	15	39	97
Range (% vs. consensus)	13%	4%	8%	19%
Company guidance	480*	360 - 380	510	n/a

Source: Bloomberg, Forsyth Barr analysis

* CEN has indicated mean hydrology EBITDAF should be ~$480m. It also indicated at its ASM that hydrology in 1Q20 was well below average.