

Electricity Sector

Still Calling the Smelter's Bluff

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The fall in electricity share prices in the past two weeks presents a buying opportunity for investors seeking high quality defensive yield. A combination of renewed NZAS closure fears and COVID-19 related fears has resulted in the increase in average gross dividend yield vs. the 10-year swap rate to 16-month highs. We continue to view the risk of NZAS closure as low and with interest rates likely to remain lower for longer, the electricity stocks are looking attractive at present.

Spread to bond rates expands

The average electricity sector gross dividend yield has increased to 6.4% from a low 5.6% in September 2019 and the spread to the 10-year swap rate has increased to 5.3%, the highest since October 2018. With interest rates more likely to trend lower, the key question for investors is whether earnings are at risk. If not, the current pull back in electricity prices represents a good buying opportunity. We are of the view that the earnings outlook has not changed.

Increased NZAS fears overstated

Part of the negative share price reaction is increased fear NZAS is about to close. In our view, nothing has changed. The losses NZAS and Rio Tinto (RIO) have reported are due mainly to higher internal alumina costs. Underlying market conditions were not materially different in 2019 vs. 2018. Second, discussions are ongoing between all parties. Whilst MEL's offer to NZAS is materially short of what NZAS is seeking, transmission remains a likely source of lower power costs. We maintain our view that NZAS is likely to remain open.

Earnings not at risk from COVID-19

The second issue impacting share prices is COVID-19. It is hard to see a scenario where electricity sector earnings would be impacted. Furthermore, central banks are reacting by lowering interest rates, helping electricity sector valuations.

Figure 1. Summary electricity sector metrics

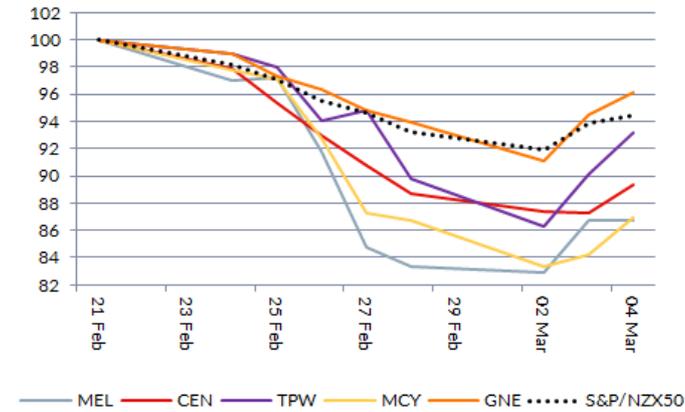
Company	Price	Target Price	Target Return	Rating	EV/EBITDA	FY20 PE	Gr Yld	EBITDAF NZ\$m
CEN	\$6.75	\$8.00	24.3%	OUTPERFORM	13.0	20.8	7.1%	441
GNE	\$3.13	\$3.15	6.4%	OUTPERFORM	14.6	28.0	7.6%	366
MCY	\$4.80	\$4.60	-0.8%	NEUTRAL	15.1	27.7	4.6%	501
MEL	\$4.81	\$4.40	-4.1%	NEUTRAL	16.1	24.6	5.6%	864
TPW	\$6.60	\$7.70	21.8%	OUTPERFORM	14.4	24.5	7.2%	187

Source: Eikon, Forsyth Barr analysis

Electricity stock sell-off

The electricity stocks have been on a roller coaster ride these past two weeks. In the same week COVID-19 fears escalated in the markets, so did renewed concerns that NZAS may actually close. The big five generator/retailers have all come under pressure as a result, with MEL and MCY the worst affected, down -13% since 21 February (and that includes a modest recovery in the past two days). This note looks at why we believe there is a strong argument that the electricity stocks should be outperforming in the current market.

Figure 2. Indexed share price movements since 21 February



Source: Eikon, Forsyth Barr analysis

Figure 3. Share price movements

	21-Feb	4-Mar	Movement
CEN	\$7.55	\$6.75	-11%
GNE	\$3.25	\$3.13	-4%
MCY	\$5.52	\$4.80	-13%
MEL	\$5.55	\$4.81	-13%
TPW	\$7.08	\$6.60	-7%

Source: Eikon, Forsyth Barr analysis

Lower interest rate outlook to provide upside for generator/retailers

There are two reasons why we believe the downside risk from COVID-19 should be a positive from a valuation perspective.

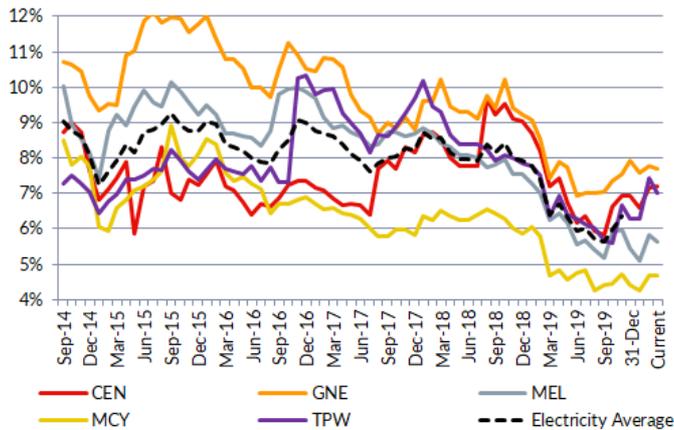
1. The earnings downside risk is limited at worst. A material reduction in electricity demand would be required to become an issue for the sector and that seems unlikely.
2. The longer the COVID-19 goes on, the more likely it is interest rates will be cut with the Fed and RBA having already moved. The 2019 share price rally in the electricity stocks was driven by falling interest rates.

Dividend yields lift as share prices fall

On a gross dividend yield basis, electricity stocks are looking more attractive than they have for a long time. The average sector yield has increased to 6.4% from a low of 5.6% in September 2019. That said, this time last year, the average sector gross dividend yield was above 7.0%.

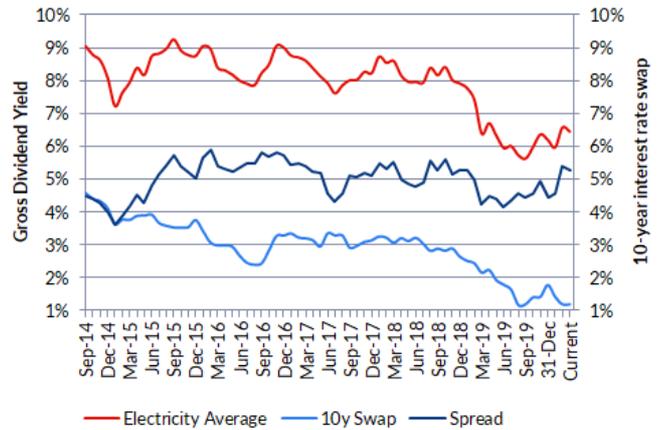
But relative to interest rates, the spread of the average electricity gross dividend yield to the 10-year swap rate has increased to 5.3%, the highest since October 2018. With interest rates facing a downward bias in the near-term, that spread is more likely to increase than decrease if share prices remain unchanged.

Figure 4. Electricity sector gross dividend yields



Source: Eikon, Forsyth Barr analysis

Figure 5. Average sector yield vs. 10-year swap rate

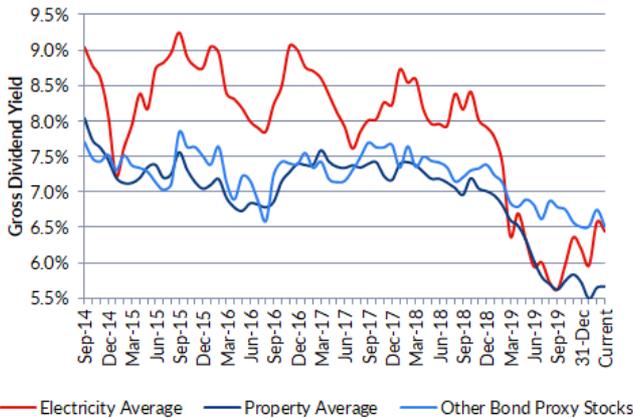


Source: Eikon, Forsyth Barr analysis

Relative to property stocks and other defensive yield assets, the electricity stocks are looking increasingly attractive. In March/April 2019 the average electricity gross dividend yield matched the property sector and largely stayed there for the next six months until the NZAS strategic review announcement in October 2019. However, in the past two weeks, that gap has accelerated, such that the electricity yields are back in line with the other bond proxies.

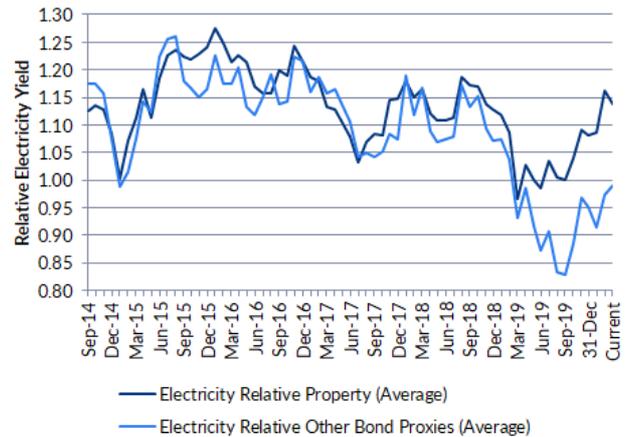
Whilst the NZAS overhang is an obvious reason for the recent relative sector performance, we believe the NZAS closure risk is very low, hence, there is more upside for the electricity sector than we have seen for a long time.

Figure 6. Electricity yield vs. property and other bond proxies



Source: Eikon, Forsyth Barr analysis

Figure 7. Relative gross dividend yield



Source: Eikon, Forsyth Barr analysis

Rio Tinto games/rumours continue – closure risk remains very low

At the same time that COVID-19 was affecting the market, there were further negative rumours relating to whether NZAS was about to close or not.

1. Rio Tinto (RIO) reported an underlying NPAT loss for Pacific Aluminium (NZ) (PacAl NZ) and an EBITDA loss for its Pacific Aluminium (PacAl) division & highlighted in its FY19 result pack that Pacific Aluminium has a high CO₂ exposure, something that RIO is seeking to minimise.
2. MEL's 1H20 result commentary regarding NZAS appears to have spooked some in the market with MEL noting its revised electricity price offer to RIO is materially lower than the price relief RIO is seeking.

In our view, neither of these "issues" are a concern.

2019 NZAS and Pacific Aluminium losses due to alumina internal charges, not a difficult market

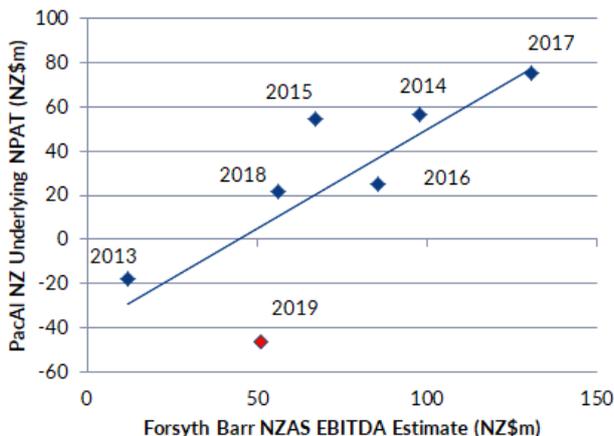
On 24 February (this is three to four months earlier than normal) RIO reported an underlying 2019 NPAT loss of -NZ\$46m (vs. +\$22m in 2018) for PacAI NZ, the subsidiary that owns 79% of NZAS. Two days later on 26 February, at its own 2019 result, RIO reported PacAI (the division that owns its four Australasian aluminium smelters) made an EBITDA loss of -US\$22m (vs +US\$148m in 2018).

Underlying market conditions in 2019 were similar to 2018, hence, the decline in PacAI NZ and PacAI earnings is surprising.

- The average LME aluminium price/alumina spread was effectively the same across 2019 and 2018, NZ\$2,049/tonne in 2019 vs. \$2,073/tonne in 2018, a decline of -1%.
- RIO has reported that the value added premium was +19% across its portfolio, up from +17% in 2018, which should offset the modest decline in the aluminium/alumina spread.
- NZAS sold 353k tonnes of aluminium, +4% more than the pcp, so should have achieved economies of scale. However, somewhat curiously NZAS opex/tonne was elevated in 2019 despite the higher production (we suspect 2018 opex was elevated due to pot line 4 being recommissioned in October 2018).

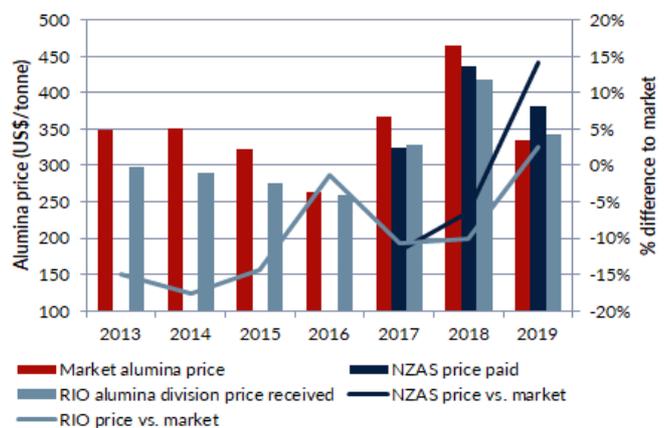
Historically, our analysis of NZAS EBITDA has been well correlated to PacAI NZ Underlying NPAT. That is not the case in 2019. Our analysis suggests NZAS made EBITDA of ~NZ\$51m in 2019, just -NZ\$5m lower than 2018. As highlighted below, the PacAI NZ loss of -NZ\$46m appears an outlier compared to previous years. Simple regression analysis (excl 2019) suggests the PacAI NZ NPAT result should have been ~NZ\$18m.

Figure 8. FB EBITDA estimate vs. PacAI NZ NPAT



Source: RIO, Forsyth Barr analysis

Figure 9. Alumina price – market vs. internal charge



Source: RIO, NZAS, Bloomberg, Forsyth Barr analysis

Further analysis indicates that the big change between 2018 and 2019 is the internal alumina charge. Relative to the alumina market price, NZAS appears to have been charged a significant premium in 2019, which has the effect of transferring profit from NZAS to RIO's Alumina division.

The price RIO's Alumina division receives has typically been a -10% to -18% discount to the market alumina price (with 2016 an anomaly). However, in 2019, that discount turned into a +2% premium. The PacAI NZ financial statements have only reported the internal alumina cost in the last three years. Nevertheless, we see a similar trend. In 2017 the price NZAS paid for alumina from RIO was very similar to RIO's Alumina division price received (a discount to the market average of -12%). In 2018 the discount reduced to -6% and in 2019 NZAS paid +14% more than the average alumina market price – a significant shift. We calculate that NZAS paid +NZ\$58m more for its alumina than it did in 2017.

Other points from NZAS financial statements

Other points to note from the NZAS financial statements that support our view NZAS will remain open:

- Our estimate of the future value of the rehabilitation provision has increased ~+NZ\$20 to ~+NZ\$360m.
- NZAS continues to assume the going concern assumption and has not impaired the asset value. NZAS auditors signed off on these assumptions, implicitly accepting the asset carrying value of NZ\$445m.

Points of note from RIO's 2019 result presentation and conference call

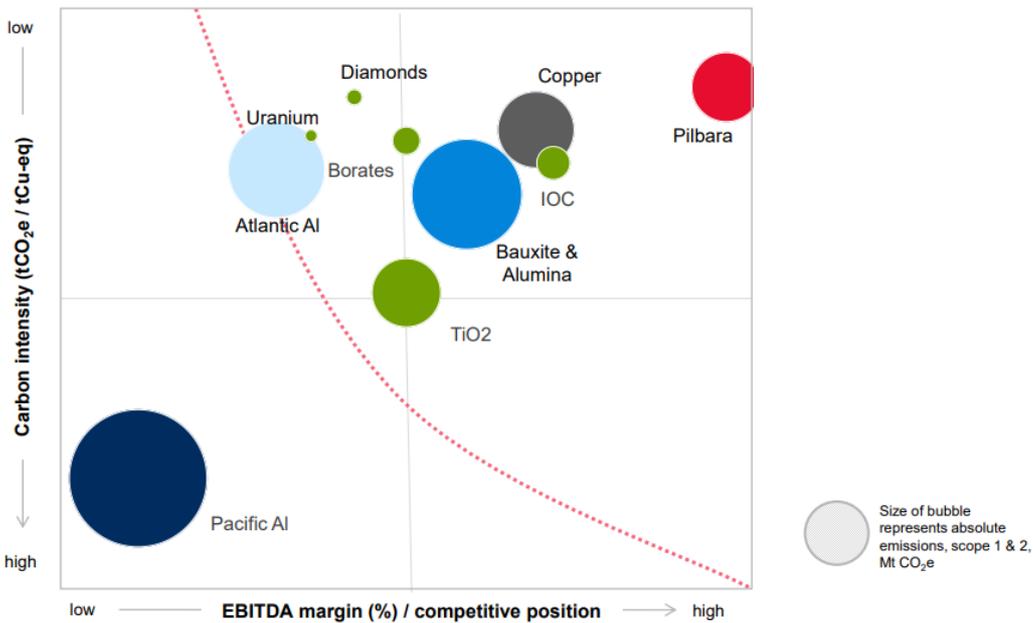
RIO's 2019 result presentation included a heavy focus on its push to de-carbonise and included the following chart (Fig. 12) that highlights PacAl is not only a high carbon emitter, but it has a poor competitive position.

We believe the chart is somewhat disingenuous, as whilst NZAS is within PacAl, NZAS's carbon intensity is very similar to RIO's Canadian hydro-backed aluminium smelters (Atlantic Al - light blue bubble). The difference in competitive position is due to RIO owning most of its Canadian hydro generation, whereas it buys electricity for NZAS.

The other points of interest from RIO's result comes from CEO's J-S Jacques answers to analyst questions.

1. In response to a question about the options for the PacAl assets, Jacques commented on three assets being challenged by electricity contracts and carbon emissions. The assets were Bell Bay in Tasmania, Tomago in NSW and Boyne in Queensland. Jacques did not mention NZAS, even though it has the formal strategic review underway.
2. Jacques rounded out the question and answer session noting that in 2030 he expects RIO's portfolio will include "really high quality iron ore. ...there will be high quality copper, high quality aluminium, that is for sure". Whilst we suspect Jacques was primarily referring to RIO's Canadian aluminium smelters, NZAS is also a high quality aluminium producer.

Figure 10. Climate change portfolio matrix – carbon intensity vs. competitive position (2018)



Source: RIO

Don't be concerned by MEL's 1H20 result comments

MEL's comments that RIO is seeking a third off its electricity bill (~NZ\$23/MWh/~NZ\$120m/~NZ\$340/tonne off a combined transmission and energy bill of ~NZ\$70/MWh/~NZ\$360m/~NZ\$1,040/tonne) and that MEL's offer is well short of what RIO is seeking has raised fears NZAS may be about to close.

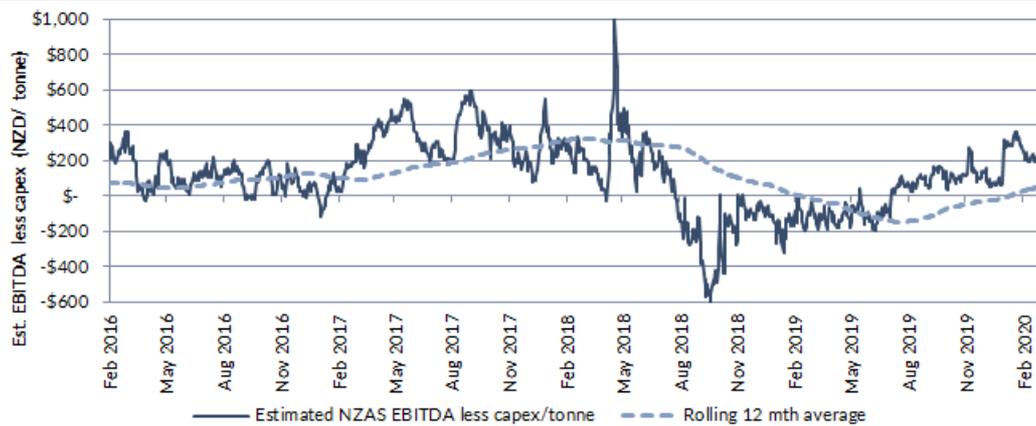
In our view this is a standard negotiation (albeit RIO has raised the stakes) and in past negotiations NZAS has never received what it was seeking. MEL also indicated that it has offered RIO a price at its "point of indifference" i.e. at the offered price, MEL is financially no worse off (in the long-term) if NZAS closed.

In addition, we continue to estimate that NZAS is cash positive at present – with those profits increasing with a lower electricity price. We estimate that the current NZAS operating profit is NZ\$265/tonne (this includes a NZ\$60m/NZ\$170/tonne lower electricity cost, with a large percentage coming from transmission). In addition, we are assuming operating costs are currently consistent with NZAS's reported 2019 operating costs, which in view were surprisingly high.

Figure 11. Estimated NZAS profitability at spot prices

		Spot
LME Aluminium price	US\$/tonne	1,706
Japan product premia	US\$/tonne	80
Value add premia	US\$/tonne	132
Estimated revenue	US\$/tonne	1,918
Alumina (two tonnes)	US\$/tonne	- 579
Gross profit	US\$/tonne	1,340
	NZDUSD	0.628
Gross profit	NZ\$/tonne	2,132
NZD opex/tonne	NZ\$/tonne	- 1,734
EBITDA/tonne	NZ\$/tonne	398
Capex/tonne	NZ\$/tonne	- 132
(EBITDA - capex)/tonne	NZ\$/tonne	265
(EBITDA - capex) (per annum)	NZ\$m	94

Source: Bloomberg, IRESS, NZAS, Forsyth Barr analysis

Figure 12. Estimated NZAS profitability (EBITDA less capex)


Source: Forsyth Barr analysis

Note: We have included an assumed \$170/tonne electricity price benefit assumed from 1 January 2020.

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