FORSYTH BARR

NEW ZEALAND EQUITY RESEARCH
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Electricity Sector
Tiwai to Overshadow Results — FY20 Preview

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Will there be an electricity sector reporting season less focussed on the actual earnings than the forthcoming FY20 results? We suspect not, with the closure of NZAS likely to dominate post-result discussions. There should be no surprises in company reported FY20 EBITDAF earnings, with sector EBITDAF dipping -3.8% to NZ$2,146m after a record FY19, although we're forecasting 2H20 EBITDAF to only slip -1.4%. Dividend decisions will be interesting, particularly for Contact Energy (CEN) and Genesis Energy (GNE).

Figure 1. FY20 reporting dates

	Contact Energy (CEN)	Genesis Energy (GNE)	Mercury (MCY)	Meridian Energy (MEL)
Reporting date	Monday, 10 August	Thursday, 20 August	Tuesday, 18 August	Wednesday, 26 August

Final dividend positioning and any FY21 commentary could be illuminating

The announcement that NZAS is closing has created significant short-term uncertainty in the electricity market. We, therefore, expect post-result discussions and company commentary to pay particular attention to the impact of NZAS closing on their business. How far earnings will fall due to NZAS closing is a key question. In that context we expect the market to be responsive to signalling contained in FY20 dividends and FY21 guidance/commentary. MEL has already signalled it will not be paying a special dividend in 2H20. CEN and GNE are the other generator/retailers most likely to trim dividends (our forecasts assume CEN and GNE will take a conservative approach and trim their dividend). However, with NZAS remaining open for a few more years a live option, there is a risk the market does not get the reassurance it is seeking as there remains a wide range of possible outcomes (albeit there is one clear downside scenario — closure on 31 August 2021).

MEL has again had a stand-out year, with earnings slipping for the other generator/retailers

The FY20 EBITDAF results should not surprise. Compared to FY19 it has been a more challenging year due to asset sales and the absence of a significant one-off benefit. That said, 2H20 has been better than 1H20, with stronger commercial and industrial prices starting to be seen in some company results (in particular MEL and MCY and to a lesser extent GNE). Whilst MEL is again the stand-out performer, and will be the only generator/retailer to grow EBITDAF, it is ironically the only generator/retailer where 2H20 EBITDAF will be less than the pcp as it benefited from a tight gas market in FY19.

Figure 2. Summary FY20 expectations

Company	CEN	GNE	MCY	MEL		CEN	GNE	MCY	MEL
EBITDAF (NZ$m)					**Full year dividend (incl specials) (cps)**				
FY20 forecast	**449**	**353**	**483**	**861**	**FY20 forecast**	**32.0**	**15.5**	**15.8**	**19.1**
FY19 result	518	370	505	838	FY19 actual	39.0	17.1	15.5	21.3
% change	-13%	-5%	-4%	3%	% change	-18%	-9%	2%	-10%
FY20 consensus	456	356	483	857	FY20 consensus	39.0	17.0	15.8	21.0
FY20 guidance	n/a	355-365	480	n/a	FY20 guidance	39.0	n/a	15.8	n/a
EPS (cps)					**Final ordinary dividend (cps)**				
FY20 forecast	**17.9**	**4.0**	**11.9**	**12.2**	**FY20 forecast**	**16.0**	**7.0**	**9.3**	**11.0**
FY19 result	24.6	7.1	11.9	13.0	FY19 actual	23.0	8.6	9.1	10.7
% change	-27%	-44%	1%	-6%	% change	-30%	-19%	2%	3%
FY20 consensus	17.9	5.4	11.7	12.4					

Source: Bloomberg, Forsyth Barr analysis

Sector talking points

These are the main topics we expect to get airtime in company commentary (outside the usual earnings commentary):

Implications of NZAS closing

NZAS closure is the elephant in the room and the generator/retailers cannot avoid talking about it. MEL has been the most vocal since the 9 July announcement that NZAS will close and with the exception of initial market releases following the NZAS announcement, the other three generator/retailer reporting in August appear to be waiting for their result announcement to provide additional commentary.

However, with discussions ongoing that may see NZAS close one to three years later than the 9 July announcement, there remains a high degree of uncertainty. MEL has been upfront with its post-NZAS strategy and we are hopeful for similar commentary from CEN, GNE and MCY. Whilst it would be good to get a sense of each company's sustainable earnings and dividends once the initial lower South Island transmission constraints are removed, we suspect the generator/retailers will be reluctant to provide that level guidance.

New build to be paused, maybe

The 1H20 result saw CEN, GNE and MEL push forward new generation projects (CEN its Tauhara geothermal project, GNE sponsoring a solar project and MEL its Hawkes Bay wind farm project). CEN has already signalled the deferral of its Tauhara project and we expect GNE will indicate the solar project has been shelved in light of the NZAS announcement. However, MEL has yet to make a decision on Harapaki, its Hawkes Bay wind project. Given the likely decline in wholesale electricity prices, prima facie we expect the project to also be deferred. MEL's challenge is the resource consents on the wind farm expire in three years. Nevertheless, in our view the business case would need to be very strong to justify building new generation in the immediate aftermath of NZAS closing.

UTS claim

On the last day of the financial year (30 June), the Electricity Authority (EA) released its draft undesirable trading situation (UTS) decision, finding MEL's market bidding behaviour in December 2019 resulted in more water being spilt than was necessary.

We expect strong push back from MEL and CEN in particular that the bidding behaviour was generally fine. The UTS decision has taken on extra meaning given spill events are more likely following the closure of NZAS.

Push-back on the 100% renewable electricity goal

Despite the Productivity Commission and Interim Climate Change Committee pointing out that targeting 100% renewable electricity is not a great goal — decarbonising energy as a whole (primarily electricity, transport and process heat) is a far better goal — the government has retained the 100% renewable electricity by 2035 goal. We expect generator/retailer commentary to again push for decarbonisation of transport and process heat ahead of electricity. We would be surprised if there is a generator/retailer that supports the Lake Onslow pumped hydro scheme that the government intends to investigate.

Sector EBITDAF to decline for the first time since FY15

For the first time since FY15 we are expecting sector EBITDAF to decline. In addition, the decline is relatively significant, down -NZ$ 84m, (-4%). However, most of the sector decline took place in 1H, with the 2H decline forecast to be only -NZ$15m, (-1%). Ironically, whilst MEL is the only generator/retailer expected to grow earnings in FY20, it is also the only generator/retailer we expect to have lower earnings in 2H20 vs. the pcp. We are forecasting MCY's 2H20 EBITDAF to lift +12% vs. 2H19, with stronger commercial and industrial pricing being the main driver.

Key factors driving the FY20 earnings decline are:

- FY19 earnings were very strong, with the sector benefiting from the Pohokura gas outage in 1H19. FY20 sector EBITDAF is in fact +NZ$74m (+4%) better than FY18, highlighting FY19 should be treated as an outlier.
- Asset sales. CEN sold its Ahuroa gas storage facility and LPG business, and MCY sold its Metrix metering business in FY19. Earnings from those discontinued businesses are a headwind for the sector to overcome.
- GNE had specific headwinds in 1H19 from reduced Kupe production (due to a planned outage) and a material increase in thermal fuel costs.

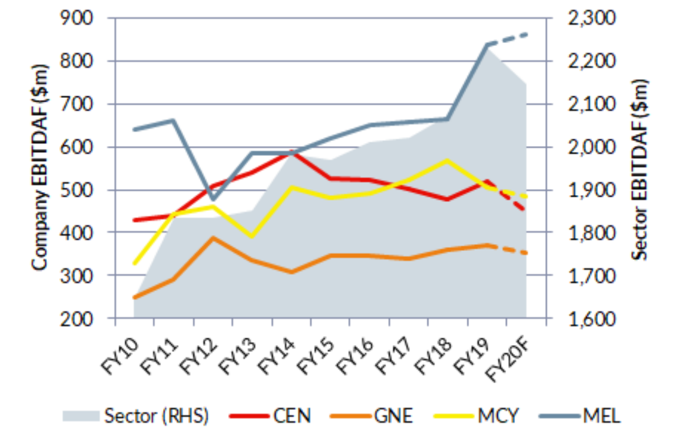
Offsetting these declines are the better earnings coming from small increases in mass market retail margins and bigger increases from commercial and industrial customers.

Figure 3. Summary FY20 EBITDAF changes vs. pcp

	EBITDAF change		
	NZ$m	%	Key drivers
CEN	(69)	-13%	Sale of LPG and Ahuroa gas storage in 1H19, tough 1Q20 hydro conditions and gas constraints lowered earnings. 2H20 in line with pcp.
GNE	(17)	-5%	A planned Kupe outage in 1H20, big increases in thermal generation fuel costs (also 1H dominated) and 2H hydro impact on earnings. We expect a strong retail performance though.
MCY	(22)	-4%	Weak hydro generation is the main driver of the soft performance. Sale of Metrix metering business in FY19 had a modest impact as well.
MEL	23	3%	Another strong year for MEL, with the retail contribution a key driver. The only generator/retailer to grow earnings in FY20.
Sector	**(84)**	**-4%**	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 4. Forecast company and sector EBITDAF



Source: Company reports, Forsyth Barr analysis

Figure 5. 2H20 EBITDAF forecast

NZ$m	2H19	2H20F	
CEN	227	228	1%
GNE	174	186	7%
MCY	203	228	12%
MEL	449	396	-12%
Sector	**1,053**	**1,038**	**-1%**

Source: Forsyth Barr analysis

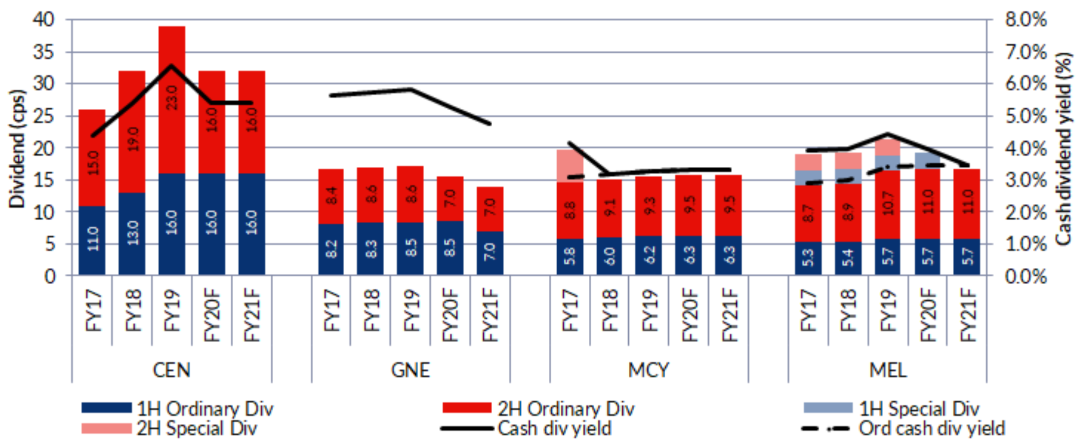
Dividend decisions and signalling more important than normal

With Rio Tinto announcing the closure of NZAS, company boards have tricky dividend decisions to make. It is not helped by the possibility NZAS may remain open for a few more years. The easiest dividend decisions are MCY and MEL.

MEL has already announced that it has suspended its "special" dividend which totalled 2.44cps every six months (4.88cps per annum). Given the FY20 result is going to be a strong one, we expect it to target the bottom of its dividend policy free cash flow payout range of 70%. That derives a final dividend of ~11.0cps.

MCY's FY20 dividend guidance is 15.8cps. Whilst it will be impacted by NZAS closing, MCY has an earnings cushion in the form of stage 1 of its Turitea wind farm coming on stream in FY21. That will give MCY the confidence to stick to FY20 dividend guidance.

Figure 6. FY20 (& FY21 dividend forecast)



Source: Company reports, Forsyth Barr analysis

CEN has only recently increased its dividend to 39cps. However, in the short-term it is one of the more affected companies from NZAS closing. In our view, it makes sense for CEN to cut the dividend now to provide its balance sheet with a little more breathing space and to minimise the risk of a credit rating downgrade. If possible, the ideal outcome is for CEN to set its dividend at a level which it believes would be sustainable through the earnings trough immediately after NZAS has closed. That would aid market confidence that the downside from NZAS closing is not too significant. The challenge is to find the right level given there is still some uncertainty around when NZAS will close and when transmission constraints will be removed.

In our view, GNE has the biggest challenge with its dividend. Similar to CEN, we believe the ideal outcome is for GNE to reset its dividend at a level it believes will be sustainable after NZAS closes. GNE had hoped earnings growth in FY21 and FY22 would enable it to reduce its gearing and payout ratio closer to the industry average. That strategy looks less tenable with NZAS closing as FY21 and FY22 earnings growth will be harder to achieve. Given its high gearing and high payout ratio, GNE has less wriggle room with its dividend. In our view, maintaining its FY20 dividend only to cut the dividend further in later periods is not a great outcome for investors. We have lowered our final FY20 dividend to 7.0cps (-1.6cps lower than the pcp) on the assumption GNE will take the conservative approach.

Outlook commentary likely to emphasise the uncertainty

The possibility NZAS stays longer than 31 August 2021 will make providing earnings and dividend guidance challenging. Normally GNE and MCY provide EBITDAF earnings guidance and CEN and MCY provide dividend guidance (GNE and MEL have fairly transparent dividend policies, but no formal guidance). We would not be surprised if the generator/retailers decide to suspend guidance — that said, we expect the market would value any guidance commentary, more so this year than normal.

Our approach to FY21 earnings is to assume that NZAS starts winding down in 2H21 and that the generator/retailers start positioning themselves for the NZAS exit — both in terms of generation and retail. There is a strong possibility that 2H21 wholesale electricity prices fall as hydro generators look to reduce hydro storage, CEN looks to use "free" TCC maintenance hours before it closes and GNE looks to run down its coal stock pile. From a retail perspective, it makes sense for MEL to start pushing to increase volumes before NZAS closes, putting early downward pressure on market retail prices (although that is unlikely to show up significantly in FY21 results).

Figure 7. FY21 EBITDAF and dividend market forecasts

EBITDAF (NZ$m)	CEN	GNE	MCY	MEL	Dividend (cps)	CEN	GNE	MCY	MEL
Forsyth Barr	446	378	499	798	Forsyth Barr	32.0	14.0	15.8	16.7
Market low	446	378	488	706	Market low	32	14	16	16
Consensus (median)	462	402	505	792	Consensus (median)	39	18	16	17
Market high	500	410	538	807	Market high	41	18	17	23
Range	54	32	50	101	Range	9	4	1	7
Range (% vs. consensus)	12%	8%	10%	13%	Range (% vs. consensus)	23%	23%	8%	41%

Source: Bloomberg, Forsyth Barr analysis

Expanded company P&L forecasts

Contact Energy (CEN)

Figure 8. CEN P&L FY20 forecast

12 months ending 30 June	FY19 NZ$m	FY20 NZ$m	Chg %	Comment
Wholesale elec sales	1,463	1,082	-26%	Lower wholesale electricity prices in FY20 vs. FY19 and decline in commercial sales volumes
Retail elec sales	863	863	0%	Mass market retail volumes are little changed from the pcp
Retail gas sales	73	75	2%	
Steam	27	28	5%	
Broadband	7	17	147%	Broadband is still a new product, hence, strong growth forecast for FY20
Other revenue	86	12	-86%	FY19 figure includes revenue from the LPG business that has now been sold
Total Revenue	**2,519**	**2,077**	**-18%**	
Electricity purchases	928	640	-31%	Big decline in purchases due to lower wholesale electricity prices
Other direct costs	855	767	-10%	Decline due to sale of LPG business and fall in lines costs due to lower comercial sales
Indirect operating costs	212	200	-6%	
EBITDAF	**518**	**449**	**-13%**	
Depreciation & amortisation	(205)	(216)	5%	
Abnormal items	174	2		Abnormal item in FY19 related to gain on sale of Ahuroa gas storage facility and LPG business
Total EBIT	**487**	**236**	**-52%**	
Net Interest	(70)	(56)	-20%	Lower gearing in FY20 due to proceeds from assets sales in FY19
Pretax	**417**	**180**	**-57%**	
Tax	(72)	(50)	-30%	
Reported NPAT	**345**	**129**	**-62%**	
Normalised Profit	**176**	**128**	**-27%**	
Normalised EPS	24.6	17.9	-27%	
FY dividend per share	39.0	32.0	-18%	We assume CEN will pull back its final dividend -7cps due to the announced NZAS closure
Final dividend per share	23.0	16.0	-30%	

Source: CEN, Forsyth Barr analysis

Genesis Energy (GNE)

Figure 9. GNE P&L FY20 forecast

12 months ending 30 June	FY19 NZ$m	FY20 NZ$m	% Chg	Comment
Energy revenue	3,255	3,178	-2%	Lower wholesale electricity prices vs. pcp
Kupe revenue	155	146	-6%	Lower FY20 Kupe production
Total Revenue	**3,410**	**3,324**	**-3%**	
Energy operating costs	(2,994)	(2,919)	-3%	
Kupe operating costs	(46)	(52)	12%	Kupe planned outage in 1H20
Energy EBITDAF	261	258	-1%	We expect a strong retail performance to be offset by a weaker wholesale market performance
Kupe EBITDAF	109	94	-13%	Kupe planned outage in 1H20
Reported EBITDAF	**370**	**353**	**-5%**	GNE EBITDAF guidance range is NZ$355m to NZ$365m
Depn & amort	(197)	(226)	15%	
FV mvmts, assoc inc, other	(11)	(9)	-15%	
EBIT	**163**	**118**	**-27%**	
Net interest	(73)	(71)	-4%	
Pre-tax profit	**89**	**48**	**-47%**	
Tax	(24)	(13)	-44%	
NPAT	**65**	**34**	**-48%**	
Normalised NPAT	**73**	**42**	**-43%**	
Normalised EPS (cps)	7.1	4.0	-44%	
FY Dividend (cps)	17.05	15.53	-8.9%	We are forecasting GNE to lower its dividend due to implications of NZAS closing — however, it may
Final dividend (cps)	8.60	7.00	-18.6%	defer this decision until there is more certainty around when NZAS closes.

Source: GNE, Forsyth Barr analysis

Mercury (MCY)

Figure 10. MCY FY20 P&L forecast

12 months to 30 June	FY19 NZ$m	FY20 NZ$m	% Chg	Comments
Sales revenue	1,957	1,729	-12%	Lower sales (and cost of sales) mainly due to lower wholesale electricity prices
Cost of sales	(1,296)	(1,073)	-17%	
Energy margin	**661**	**656**	**-1%**	
Other revenue	43	19	-56%	Decline due to sale of Metrix metering business in 2H19
Other operating costs	(199)	(192)	-4%	
EBITDAF	**505**	**483**	**-4%**	2H20 hampered by very low hydro inflows. MCY EBITDAF guidance is NZ$480m
Depn & amort	(204)	(207)	2%	
FV mvmts, assoc inc, other	204	(15)	-107%	FY19 result included gain on sale of the Metrix metering business
EBIT	**505**	**260**	**-48%**	
Net interest	(75)	(58)	-23%	Decline in effective interests and capitalised interest are the main drivers of lower interest costs
Pre-tax profit	**430**	**203**	**-53%**	
Tax	(73)	(48)	-35%	
NPAT	**357**	**155**	**-56%**	
Normalised NPAT	**161**	**162**	**1%**	
EPS (cps)	11.9	11.9	1%	
FY dividend (cps)	15.5	15.8	2%	Our dividend forecast is consistent with MCY guidance
Final dividend (cps)	9.1	9.3	2%	

Source: MCY, Forsyth Barr analysis

Meridian Energy (MEL)

Figure 11. MEL FY20 P&L forecast

12 months to 30 June	FY19 NZ$m	FY20 NZ$m	% Chg	Comments
NZ Energy Margin	1,108	1,123	1%	Strong retail performance (big lift in sales volumes and prices), offset by weaker wholesale electricity prices
Australia Energy Margin	118	123	4%	Big increase in retail contribution offset by weak generation volumes and lower wholesale electricity prices
Energy Margin	**1,226**	**1,245**	**2%**	
Other revenue	25	26	6%	
Transmission costs	(131)	(123)	-6%	Lower HVDC costs in 4Q20 the main contributor to lower transmission costs
Operating costs	(282)	(288)	2%	
EBITDAF	**838**	**861**	**3%**	Another record financial performance
Depn & amort	(276)	(314)	14%	
EBIT	**562**	**547**	**-3%**	
Net interest	(83)	(84)	1%	
FV mvmts, assoc inc, other	(14)	(10)	-29%	
Pre-tax profit	**465**	**453**	**-3%**	
Tax	(133)	(127)	-5%	
NPAT	**332**	**326**	**-2%**	
Normalised NPAT	**332**	**312**	**-6%**	
EPS (cps)	13.0	12.2	-6%	
Dividend (cps)	21.3	19.1	-10%	Decline reflects MEL's decision to cease its "special" dividend
Final dividend (cps)	13.2	11.0	-16%	We are forecasting a small increase (+2.6%) in the final ordinary dividend, offset by no "special"

Source: MEL, Forsyth Barr analysis

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