FORSYTH BARR

NEW ZEALAND EQUITY RESEARCH
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Electricity Sector
Sector Up, Meridian Down

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We are anticipating a strong set of 1H21 EBITDAF results with three of the four reporting generator/retailers increasing EBITDAF and sector EBITDAF increasing +3.2% to NZ$1.14b. Following a weak 1H20 outcome, Genesis Energy (GNE) will likely lead the charge with forecast EBITDAF growth of +24%. With NZAS confirming it will stay open for now, we expect sector commentary to focus on new builds, and in light of the Climate Change Commission (CCC) report, electricity's role in decarbonising the economy. However, an effect of the discounted electricity price to keep NZAS open is lower sector dividends and we are forecasting the sector interim dividend to decline -13% to NZ$436m, due mainly to Meridian Energy (MEL) no longer paying a special dividend. Contact Energy (CEN) is, as usual, the first company to report on Monday, 15 February.

Figure 1. Summary result expectations

Company Reporting date	Contact Energy (CEN) Monday, 15 February	Genesis Energy (GNE) Thursday, 25 February	Mercury (MCY) Tuesday, 23 February	Meridian Energy (MEL) Wednesday, 24 February
1H21 EBITDAF forecast ($m)	246	207	268	422
1H20 actual ($m)	221	167	255	465
% change	11%	24%	5%	-9%
1H21 EPS forecast (cps)	9.1	4.7	6.7	6.1
1H20 actual (cps)	8.0	1.6	6.6	7.2
% change	14%	194%	2%	-15%
1H21 dividend forecast (incl special dividends) (cps)	15.0	8.650	6.8	5.70
1H20 actual (incl special dividends) (cps)	16.0	8.525	6.4	8.14
% change	-6.3%	1.5%	6.3%	-30.0%

Source: Forsyth Barr analysis

Sector earnings uptick, but MEL bucks the trend

We are forecasting 1H21 sector EBITDAF to increase +3.2%, with increased retail prices, lower thermal fuel prices and normal production from Kupe being the main drivers. Given its recent track record of strong earnings growth, it is unusual for MEL to be the only company we expect to have lower 1H21 earnings vs. 1H20. That said, MEL is lapping a record 1H20 result and our 1H21 EBITDAF forecast is the second highest on record, +8% better than 1H19.

Sector dividends to track backwards following big NZAS electricity price discount, special dividends to become a historic relic

We are forecasting both CEN and MEL to reduce their interim dividends, due to the discounted electricity both companies are now providing NZAS. MEL's -30% lower dividend is due to it no longer paying a special dividend. Special dividends have been a feature of generator/retailers shareholder returns in recent years, as the companies return surplus capital to shareholders. Looking ahead, we do not foresee special dividends being common as the generator/retailers look to reinvest capital into new generation projects.

Now is the time to build, and we expect the green light for at least two new developments

With NZAS providing some short-term certainty, the Climate Change Commission reiterating electricity demand growth will be required to decarbonise the economy and the wholesale electricity market sending a strong price signal that more generation is required, we expect at least two projects to get the green light this reporting season. CEN's Tauhara geothermal project is the most likely to get approval. MEL's Harapaki wind farm is also a strong chance to go ahead. GNE needs to build 1,350GWh of renewable energy to meet its 2025 pledge and so there is a possibility it announces support for a new project as well. Mercury (MCY) has its hands full with its under- construction Turitea wind farm and so there is little chance it will be announcing a new project.

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GNE to produce biggest earnings increase

Somewhat unusually for recent years, MEL is not leading the sector with earnings growth, but is instead the only company to have shrinking earnings (although 1H20 was a record period for MEL and our 1H21 EBITDAF forecast is its second highest 1H earnings). Instead, it is GNE leading the growth statistics with our forecast 1H21 EBITDAF of NZ$207m +24% higher than 1H20. Sector earnings growth is forecast to grow +3.2% to NZ$1,143m. The key factors supporting sector growth are:

- Increased retail margins. Wholesale electricity prices have been elevated well above the long-run marginal cost (LRMC) of new generation for more than two years. That has gradually filtered into retail prices at both the commercial and mass market level.
- GNE's 1H20 earnings were negatively impacted by the significant planned Kupe outage and increased fuel costs (primarily coal). This ~NZ$30m headwind is not a feature of 1H21.
- Acting as a slight headwind has been reduced low cost renewable electricity generation (down -3%, ~-550GWh), in particular South Island hydro generation which was down more than 400GWh.

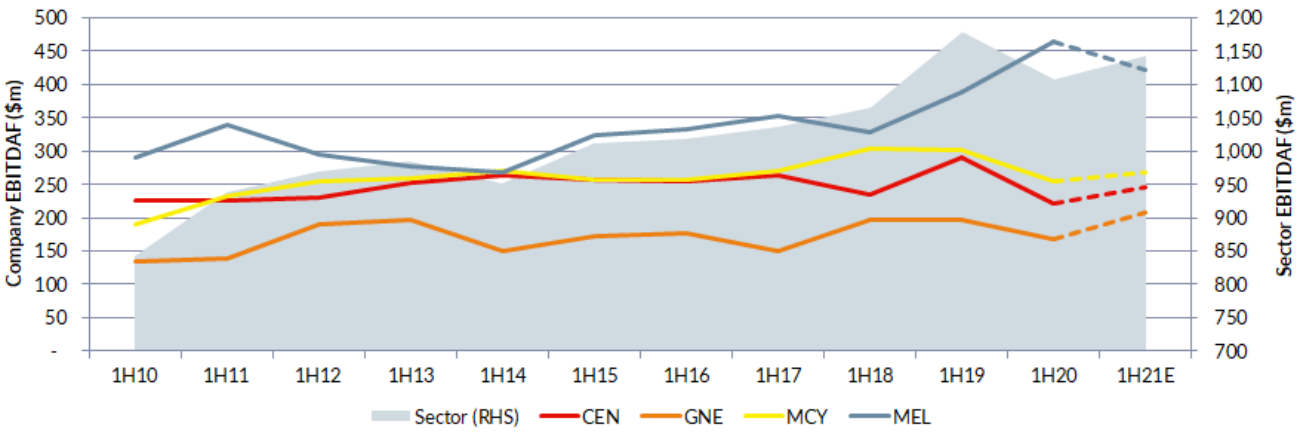
Whilst 1H21 is going to be better than 1H20, sector EBITDAF is still ~-NZ$35m below the record 1H19 period. However, 1H19 benefitted from the initial Pohokura gas outage impacting wholesale electricity prices, as well as including earnings from assets that have subsequently been sold (CEN's Ahuroa gas storage and Rockgas LPG business and MCY's Metrix metering business).

Figure 2. Summary forecast 1H21 EBITDAF movement vs. 1H20 and commentary

	EBITDAF Change		
	NZ$m	%	Key drivers
CEN	25	11%	Good 1Q21 hydro generation lapping a weak 1Q20 period is enough to provide CEN with a solid earnings uplift
GNE	40	24%	GNE is lapping a weak period impacted by a planned Kupe outage and high thermal generation fuel costs
MCY	13	5%	A strong trading period in 2Q21 has enabled MCY to offset a reasonable (-8%) fall in hydro generation in 1H21
MEL	(43)	-9%	1H20 was a record earnings period for MEL and generation volumes are down -7% in 1H21
Sector	**35**	**3%**	A solid uplift in sector earnings, driven by retail price increases and weakness in some company comparator earnings

Source: Forsyth Barr analysis

Figure 3. Forecast company and sector EBITDAF



Source: Company reports, Forsyth Barr analysis

Dividend cuts outweigh dividend increases for the first time

NZAS overhung the generator/retailers dividend outlook for much of 1H21. The announcement that NZAS will remain open until at least 2024 has provided increased dividend certainty. Nevertheless, we are forecasting both CEN and MEL to cut interim dividends (albeit MEL is a cut of the special dividend, not the ordinary dividend). In total, we are forecasting the interim sector dividend to fall -NZ$63m (-12.6%) to NZ$436m.

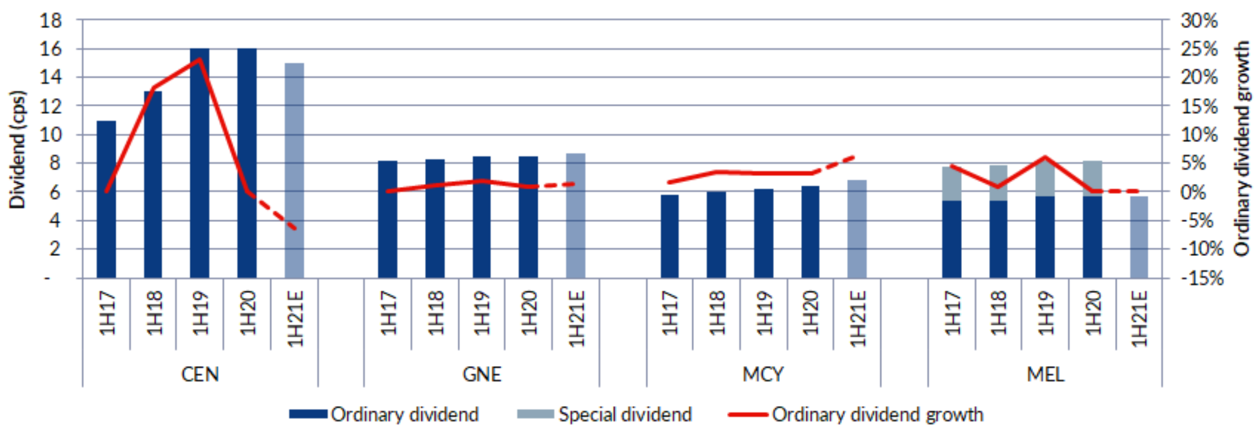
CEN has yet to provide FY21 dividend guidance following the announcement NZAS is staying open for longer, hence, there is more uncertainty surrounding its dividend than for the other generator/retailers. Our FY21 dividend forecast of 36cps, -3cps lower than the prior two years' 39cps dividend. We currently assume a -1cps reduction to the interim dividend (16cps to 15cps) and a -2cps reduction to the final dividend (23cps to 21cps). The earnings impact of CEN's support for NZAS's lower electricity price is the main driver, but CEN will also be factoring in the need for capital ahead of it building Tauhara and the financial effects of the ongoing gas supply shortage.

In our view, MEL is more straight forward. It has already stopped paying a special dividend (this happened at the FY20 result). We expect a flat interim dividend of 5.7cps. Whilst 1H21 earnings are solid (in fact the second highest on record), 2H21 earnings are looking less certain given dry conditions and will be impacted by the reduction in NZAS revenue. In addition, we believe there is a strong chance MEL will indicate it plans to build its wind farm development option, meaning it will err towards wanting to hold on to capital.

We anticipate GNE will continue to modestly grow its dividend +1.5% to 8.65cps, consistent with its dividend policy to grow its dividend by at least inflation.

MCY's interim dividend forecast of 6.8cps (+0.4cps, +6.3%) is the sector's fastest growing interim dividend and has been dictated by its 17.0cps FY21 dividend guidance. Whilst MCY has recently upgraded EBITDAF to NZ$535m, +NZ$20m higher than its initial FY21 EBITDAF guidance, which could support an additional +1.0cps dividend, we do not anticipate an increase in dividend guidance or a special dividend. With the sector likely moving into a growth capex phase in the coming years, we expect MCY will be wary about retaining balance sheet capacity.

Figure 4. Interim dividend forecast



Source: Forsyth Barr analysis

Expected talking points

As usual there is plenty to talk about in the electricity sector. These are the topics we expect to get airtime during the reporting season:

- **New build:** With NZAS confirmed to remain open until at least 31 December 2024, we expect CEN and MEL to give the green light to their respective development projects, the 150MW Tauhara geothermal project and the 170MW Harapaki wind farm project. We expect GNE will have contracted to buy some of Tauhara's power, but there is also the possibility it will announce it is supporting an additional renewable generation project. A year ago, GNE raised the prospect of supporting the development of Waikato solar farm. Given its pre-Christmas pledge to increase renewable energy +1,350GWh by 2025 it likely has to support a further three projects in the next three years (in addition to the Waipipi wind farm that is currently in its commissioning phase).
- **Climate Change Commission (CCC) report:** On 31 January, the CCC released its draft report on how NZ needs to decarbonise. Given it has reiterated the central role electricity will play, we expect unanimous sector support for the report. In particular, we expect the generator/retailers to echo the CCC's sentiment that NZ should have a renewable *energy* target as opposed to a renewable *electricity* target.
- **NZ Battery Project:** Whilst it has yet to start, we expect some comment on the NZ Battery Project, which amongst other things will be making an assessment of the proposed Lake Onslow pumped hydro scheme. That said, it is probably too early for any of the generator/retailers to put forward alternative solutions to the ex-Rankines dry year reserve problem.
- **Current wholesale electricity market conditions:** Hydro conditions are below average at present which is more concerning than usual because of ongoing gas constraints limiting back-up thermal generation. 2021 would not be a great year to have electricity supply concerns given the Battery Project and the high level of political attention the sector is currently receiving.

FY21 outlook — what might happen to earnings and dividend forecasts

There is currently a reasonable degree of divergence in market FY21 EBITDAF and dividend forecasts, particularly for CEN and MEL. We currently have the low market forecasts for both stocks, and so we believe there is downside risk to consensus forecasts for both of the companies. Our MCY EBITDAF forecast is currently the high in the market, although given MCY's FY21 EBITDAF guidance of NZ$535m we do not anticipate any positive share price reaction to an increase in FY21 consensus forecasts.

There is little or no divergence on GNE and MCY dividend forecasts, but the same cannot be said for CEN and MEL. We expect dividend forecasts to tighten once CEN and MEL reveal their interim dividends and likely direction of their FY21 dividends.

Figure 5. FY21 consensus

EBITDAF (NZ$m)	CEN	GNE	MCY	MEL	Dividend (cps)	CEN	GNE	MCY	MEL
Forsyth Barr	456	408	538	714	Forsyth Barr	36.0	17.5	17.0	16.9
Market low	456	392	496	714	Market low	33.0	17.0	17.0	16.9
Consensus (median)	477	404	506	754	Consensus (median)	36.5	17.4	17.0	17.3
Market high	499	413	538	797	Market high	39.0	17.5	17.0	19.0
Range ($m)	43	21	42	83	Range (cps)	6.0	0.5	0.0	2.1
Range (% vs. consensus)	9%	5%	8%	11%	Range (% vs. consensus)	16%	3%	0%	12%
Guidance	n/a	395-415	535	n/a		n/a	n/a	17.0	n/a

Source: Bloomberg, Eikon, Forsyth Barr analysis

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