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Electricity Sector
S&P Clean Energy Index Consultation Threepeat

ANDREW HARVEY-GREEN
andrew.harvey-green@forsythbarr.co.nz
+64 4 495 8185

SCOTT ANDERSON
scott.anderson@forsythbarr.co.nz
+64 4 914 2219

The upshot of S&P's third go at changing its Global Clean Energy (GCE) Index rules, (despite seemingly finalising new rules mid-February), is a probable further reduction of the GCE Index weights of Contact Energy (CEN) and Meridian Energy (MEL). We estimate that under the proposed changes the ETFs that track the index will be required to sell between 72m–78m shares in CEN (~9% of free float) and between 100m–109m shares in MEL (~8% of free float). The exact amount will depend on the size and liquidity of new GCE Index constituents. The consultation doesn't mention a change to the US$3m six month MDVT (median daily traded value) entry threshold, meaning we expect Mercury (MCY) will still miss out on inclusion.

Figure 1. Estimated selling under Feb-21 rules, vs. proposed rules. Size of new constituents is key

	Current	Scenario 1	Scenario 2	Scenario 3	Feb-21 proposal
Avg free-float market cap of new constituents (US$b)		3.5	6.9	10.4	
CEN weighting	4.0%	0.66%	0.47%	0.37%	1.11%
MEL weighting	4.7%	0.74%	0.53%	0.41%	1.24%
CEN ETF shares	86	14	10	8	23
MEL ETF shares	119	19	13	10	31
CEN shares to sell		(72)	(76)	(78)	(63)
MEL shares to sell		(100)	(106)	(109)	(88)

Source: ICLN, Eikon, Forsyth Barr analysis

New proposals will increase the number of GCE Index constituents, diluting CEN and MEL further

The key proposed change impacting CEN and MEL is the increased target constituent count of 100, which will dilute MEL and CEN's weightings. To enable more constituents, S&P is proposing to lower the "clean energy" requirement, allowing companies with a "significant clean energy exposure" to enter the GCE Index. Currently there are 30 GCE constituents. If S&P applied the proposed rules at the October 2020 rebalance there would be 68 constituents, meaning as more companies meet the criteria the constituent count will increase towards 100 over time. A comparison of the current rules, the Feb-21 rule changes and the latest proposal are detailed in Figure 2.

Proposed rules increase the black box element of the GCE Index

It is harder to estimate the potential impact on CEN and MEL from the proposed rule changes, although there will extra ETF selling. It is unclear how S&P assesses the "clean energy" aspect of constituents. With a lower clean energy threshold required to enter the GCE Index, it is possible some very large companies will now enter. Large, liquid companies entering the GCE Index will dilute CEN and MEL the most. The current largest constituent has a free float market cap of US$35b, whilst the median is US$3.5b of the 30 constituents (CEN is US$3.7b and MEL US$4.8b). In addition, liquidity plays a bigger role than it used to and with MEL (US$8.9m) and CEN (US$7.9m) MDVT liquidity well below the median of current constituents (US$36m), their respective GCE Index weightings are going to be much lower than in the past.

CEN offers great value, MEL still looks expensive

Whilst there is short-term downside risk to CEN, we see good value at current levels. It is trading on an FY21 gross dividend yield of 6.9% (which we expect to grow in coming years) and an FY22 EV/EBITDAF 11.9x. In comparison MEL's gross dividend yield is 4.2% and FY22 EV/EBITDAF 20.6x. Our CEN rating is OUTPERFORM and our MEL rating is UNDERPERFORM.

Key proposed changes to GCE Index rules

Consultation on the new proposal is open until Friday, 19 March (which also happens to be the record date for rebalance changes). If these changes are made, they will take effect on Friday, 16 April, with S&P releasing the changes on Friday, 2 April.

Figure 2. Summary of GCE Index changes

Index changes	Current rules	New rules as per 11 February changes	Proposed rules as per 4 March consultation
Constituent weighting	Weightings are based on the product of a company's float adjusted market cap (FMC) and exposure score[1]. Capped at 4.5%.	Weightings are still based on FMC and exposure score, however, the weighting is now capped at the lower of a) 9%, or b) 5x the liquidity weight[2] of a company. In addition, the sum of all companies with weights above 4.5% cannot exceed 40% of the total index.	Weighting formula remains the same, except the 9% cap is replaced with a cap that is dependent on the constituent's exposure score: ▪ 8% for an exposure score of 1 ▪ 6% for an exposure score of 0.75 ▪ 4% for an exposure score of 0.5
Liquidity measure	To qualify for inclusion, a stock *average* daily value traded (ADVT) must be above US$3m for the three months prior to the inclusion. To remain in the index a stock must have a three month ADVT of US$2m.	Liquidity is moving to a six month *median* daily trade value (MDVT) measure. With US$3m still the threshold to enter and US$2m still the threshold to remain in the index.	No change to revised 11 February rules.
Constituent count	30	Minimum of 35 stocks. If there are fewer than 35 stocks with exposure scores of 1, then the highest ranked stocks with an exposure score of 0.5 are selected until the mimum of 35 constituents is reached. There is no maximum number of constituents.	Target constituent count of 100, with a minimum weighted average exposure score of 0.85. If there are more than 100 companies with exposure scores of 1, then all will be included (i.e. there is no maximum if all companies have an exposure score of 1). If there is less than 100, then companies with exposure scores of 0.75 will be selected until the weighted average exposure score of 0.85 is reached.
Rebalancing	Semi-annual index reconstruction after close of business (US time) on the third Friday of April and October. The reference date for the rebalancing is the third Friday of the month prior (i..e March and September).	Semi-annual reconstructions remain, however, there is also additional quarterly re-weighting after close on the third Friday of January and July.	No change, revised 11 February rules.
Exposure score	▪ 0 = Eliminated, no exposure ▪ 0.5 = Multi-industry with significant clean energy exposure ▪ 1 = Primary business is clean energy	No change	The introduction of a 0.75 exposure score, with exposure scores re categorised as: ▪ 0 = Eliminated, no exposure ▪ 0.5 = Moderate clean energy exposure ▪ 0.75 = Significant clean energy exposure ▪ 1 = Maximum clean energy exposure

Source: S&P, Forsyth Barr analysis

Note:

[1] Currently all companies in the index have an exposure score of 1. An exposure score of 1 indicates that a company's primary business is clean energy.

[2] Liquidity Weight Multiple Cap = Multiple *(Stock Liquidity/Aggregate Liquidity of all Stocks), where Stock Liquidity = Six -month MDVT.

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