

Freightways

Posting a Better Margin Outlook

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OUTPERFORM

Freightways (FRE) has a key opportunity to lift profitability in its core parcels operations in light of a more rational competitive backdrop, in our opinion. Its biggest competitor, NZ Post, has shifted its mindset from the public good to a commercially focussed business. NZ Post's latest annual report (for its 2020 financial year) provides several key statements that support a strategic desire to lift profitability significantly from current levels. This strongly suggests a continuation of the current positive pricing environment and supports an expanding industry profit pool. We believe this will allow FRE's 'pricing for effort' strategy to make further pricing gains in the lower margin but higher growth, business-to-consumer (B2C) channel, which is consistent with the assumptions behind our current above market consensus earnings forecasts. Consequently, FRE earnings outlook remains strong and with it trading at an undemanding one year forward PE of ~19x, we reiterate an OUTPERFORM rating.

NZX Code	FRE	Financials: Jun/	20A	21E	22E	23E	Valuation (x)	20A	21E	22E	23E
Share price	NZ\$9.38	NPAT* (NZ\$m)	56.0	76.3	86.6	93.4	PE	26.5	20.4	17.9	16.6
Target price	NZ\$10.50	EPS* (NZc)	35.5	46.1	52.3	56.4	EV/EBIT	24.1	16.0	14.5	13.6
Risk rating	Medium	EPS growth* (%)	-9.7	30.0	13.5	7.8	EV/EBITDA	14.1	11.0	10.3	9.8
Issued shares	165.6m	DPS (NZc)	15.0	34.6	39.2	42.3	Price / NTA	n/a	n/a	n/a	n/a
Market cap	NZ\$1,554m	Imputation (%)	100	100	100	100	Cash div yld (%)	1.6	3.7	4.2	4.5
Avg daily turnover	198.9k (NZ\$1,435k)	*Based on normalised profits					Gross div yld (%)	2.2	5.1	5.8	6.3

Material issues

Each year NZ Post publishes a list of the most important issues that "could significantly impact [its] business performance". The most important issue this year, determined by its internal and external engagement process, is "commercial mindset", reflecting the need to improve profitability, use of resources and prioritisation of opportunities. This is further acknowledgement that improving its return on capital is more a necessity rather than aspiration. The company's evolution to a more commercially focussed organisation has been in place for several years under current management as evidenced by consistent above trend pricing initiatives.

Financial targets for parcels

NZ Post has indicated aggressive parcel profitability goals for the next few years. It is targeting a "return on parcel revenue" or EBIT margin improvement from 2.5% in FY21 to 9.3% in FY23. Assuming ongoing volume growth, this equates to >NZ\$50m additional EBIT to the parcel industry profit pool, which has historically been dominated by FRE's high margin B2B (business-to-business) focussed operations. Notwithstanding scope for operating leverage benefits to accrue from volume growth, we anticipate further above trend pricing action will be necessary to meet these targets.

Parcel quality impacted by COVID-19

NZ Post was put under considerable strain as ecommerce activity boomed on the transition from Alert Level 4 to 3. It was unable to manage the significant increase in parcel demand, materially in excess of its previous activity peak (for which it would typically plan months in advance for), and delivery quality suffered. The proportion of parcels delivered on time fell to ~91% in FY20 from 96% in FY19, with the decline likely concentrated in the fourth quarter. We expect its quality to improve through FY21.

Freightways Ltd (FRE)

 Priced as at 24 Nov 2020 (NZ\$) **9.38**

12-month target price (NZ\$)*	10.50
Expected share price return	11.9%
Net dividend yield	3.9%
Estimated 12-month return	15.8%

Key WACC assumptions	
Risk free rate	1.30%
Equity beta	1.00
WACC	6.1%
Terminal growth	1.0%

Profit and Loss Account (NZ\$m)	2019A	2020A	2021E	2022E	2023E
Sales revenue	615.7	630.9	803.1	837.5	874.3
Normalised EBITDA	112.2	144.7	184.3	195.9	205.4
Depreciation and amortisation	(17.5)	(50.4)	(57.3)	(57.3)	(57.5)
Normalised EBIT	97.1	84.7	127.0	138.6	147.9
Net interest	(9.6)	(18.4)	(19.2)	(16.4)	(16.3)
Associate income	0	0	0	0	0
Tax	(24.1)	(18.0)	(31.5)	(35.5)	(38.2)
Minority interests	0	0	0	0	0
Normalised NPAT	61.0	56.0	76.3	86.6	93.4
Abnormals/other	2.4	(8.7)	0	0	0
Reported NPAT	63.4	47.4	76.3	86.6	93.4
Normalised EPS (cps)	39.3	35.5	46.1	52.3	56.4
DPS (cps)	30.5	15.0	34.6	39.2	42.3

Growth Rates	2019A	2020A	2021E	2022E	2023E
Revenue (%)	6.0	2.5	27.3	4.3	4.4
EBITDA (%)	4.2	28.9	27.4	6.3	4.8
EBIT (%)	2.9	-12.7	49.9	9.1	6.7
Normalised NPAT (%)	2.4	-8.2	36.2	13.5	7.8
Normalised EPS (%)	2.2	-9.7	30.0	13.5	7.8
Ordinary DPS (%)	2.5	-50.8	>100	13.5	7.8

Cash Flow (NZ\$m)	2019A	2020A	2021E	2022E	2023E
EBITDA	112.2	144.7	184.3	195.9	205.4
Working capital change	0	0	0	0	0
Interest & tax paid	(33.7)	(28.6)	(41.4)	(42.6)	(45.1)
Other	(2.5)	11.1	(14.0)	(14.0)	(14.0)
Operating cash flow	76.0	127.2	128.9	139.2	146.2
Capital expenditure	(23.3)	(23.6)	(23.3)	(27.6)	(28.9)
(Acquisitions)/divestments	(8.7)	(101.6)	0	0	(38.4)
Other	1.9	(24.0)	(25.0)	(25.0)	(25.0)
Funding available/(required)	46.0	(22.0)	80.7	86.6	54.0
Dividends paid	(47.0)	(47.5)	(28.6)	(65.0)	(70.1)
Equity raised/(returned)	0.7	24.1	0	0	0
(Increase)/decrease in net debt	(0.3)	(45.4)	52.0	21.7	(16.1)

Balance Sheet (NZ\$m)	2019A	2020A	2021E	2022E	2023E
Working capital	23.8	18.7	22.9	23.6	24.4
Fixed assets	106.7	134.6	130.5	130.6	131.7
Intangibles	365.2	499.0	504.3	509.6	528.0
Right of use asset	0	278.1	278.1	278.1	278.1
Other assets	4.0	15.6	15.6	15.6	15.6
Total funds employed	499.7	946.1	951.3	957.5	977.8
Net debt/(cash)	151.4	205.0	153.0	131.3	147.4
Lease liability	0	311.1	311.1	311.1	311.1
Other liabilities	74.3	113.2	113.2	113.2	113.2
Shareholder's funds	273.9	316.7	374.0	401.8	406.0
Minority interests	0.1	0.1	0.1	0.1	0.1
Total funding sources	499.7	946.1	951.3	957.5	977.8

* Forsyth Barr target prices reflect valuation rolled forward at cost of equity less the next 12-months dividend

Spot valuations (NZ\$)	
1. DCF	10.50
2. Sum-of-the-parts	9.97
3. n/a	n/a

DCF valuation summary (NZ\$m)	
Total firm value	2,671
(Net debt)/cash	(198)
Less: Capitalised operating leases	(735)
Value of equity	1,738

Valuation Ratios	2019A	2020A	2021E	2022E	2023E
EV/EBITDA (x)	15.2	11.9	9.4	8.7	8.3
EV/EBIT (x)	17.6	20.4	13.6	12.3	11.5
PE (x)	23.9	26.5	20.4	17.9	16.6
Price/NTA (x)	n/a	n/a	n/a	n/a	n/a
Free cash flow yield (%)	3.4	6.7	6.8	7.2	7.6
Net dividend yield (%)	3.3	1.6	3.7	4.2	4.5
Gross dividend yield (%)	4.5	2.2	5.1	5.8	6.3

Capital Structure	2019A	2020A	2021E	2022E	2023E
Interest cover EBIT (x)	10.1	4.6	6.6	8.4	9.1
Interest cover EBITDA (x)	11.7	7.9	9.6	11.9	12.6
Net debt/ND+E (%)	35.6	39.3	29.0	24.6	26.6
Net debt/EBITDA (x)	1.3	1.4	0.8	0.7	0.7

Key Ratios	2019A	2020A	2021E	2022E	2023E
Return on assets (%)	16.6	8.1	12.0	12.9	13.5
Return on equity (%)	22.3	17.7	20.4	21.6	23.0
Return on funds employed (%)	12.6	12.0	18.2	18.4	18.6
EBITDA margin (%)	18.2	22.9	23.0	23.4	23.5
EBIT margin (%)	15.8	13.4	15.8	16.5	16.9
Capex to sales (%)	3.8	3.7	2.9	3.3	3.3
Capex to depreciation (%)	151	50	44	53	55
Imputation (%)	100	100	100	100	100
Pay-out ratio (%)	78	42	75	75	75

Operating Performance	2019A	2020A	2021E	2022E	2023E
Revenue (NZ\$m)					
Express Package & Bus. Mail	451.3	472.2	635.0	654.1	683.5
Information Mgmt	164.4	158.8	168.1	183.4	190.9
Total Sales	615.7	630.9	803.1	837.5	874.3

EBITDA (NZ\$m)	2019A	2020A	2021E	2022E	2023E
Express Package & Bus. Mail	80.0	101.7	136.5	142.6	149.0
Information Mgmt	35.3	47.1	53.8	59.6	63.0
H/Office	(3.1)	(4.1)	(6.0)	(6.3)	(6.6)
Total EBITDA	112.2	144.7	184.3	195.9	205.4

EBITDA margin (%)	2019A	2020A	2021E	2022E	2023E
Express Package & Business Mail	17.7	21.5	21.5	21.8	21.8
Information Mgmt	21.5	29.6	32.0	32.5	33.0
Group EBITDA margin	18.2	22.9	23.0	23.4	23.5

NZDAUD	0.91	0.95	0.91	0.90	0.89
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NZ Post's material issues

NZ Post determines "material issues" as either risks or opportunities as determined by its stakeholders (internal and external) that could significantly impact business performance over the medium or long term. The resulting issues are prioritised and addressed through management actions.

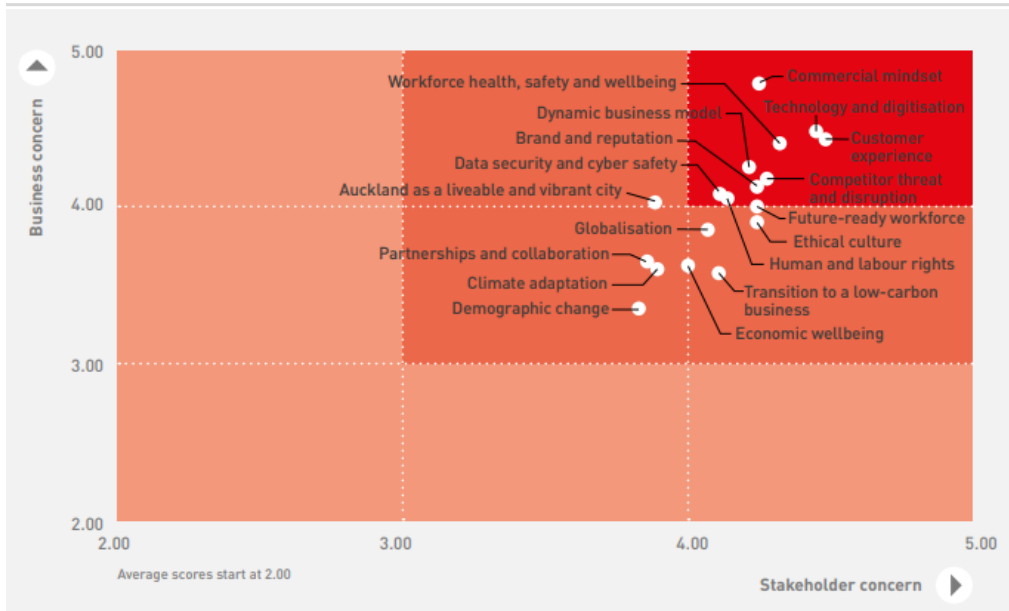
In the 2020 material issues, "*commercial mindset*" came through as the number one issue internally and in the combined averages. External stakeholders rated this less highly (11th) and continued to rank "*customer experience*" as the most material issue. This is the first time since 2016 that there has been a change to the top five issues with data security and cyber safety down to 9th from 2nd in 2019.

Figure 1. NZ Post's key material matters by year (in order of importance)

	2020	2019	2018	2017	2016	2015
1	Commercial mindset	Customer experience	Changing customer needs	Digitisation	Changing customer needs	Customer needs
2	Technology & Disruption	Data security and cyber safety	Digitisation	Changing customer needs and expectations	Digitisation	Transformation
3	Customer experience	Dynamic business model	Data security and cyber safety	Continued business transformation	Business transformation	Digitisation
4	Workforce health, safety and wellbeing	Workforce health, safety and wellbeing	Continued business transformation	Brand and reputation	Ability to attract, nurture and retain talent	Talent management
5	Dynamic business model	Digitisation	Health, safety and wellbeing	Future ready workforce	Brand and reputation	Brand reputation
6	Competitor threat and disruption	Brand and reputation	Future ready workforce	Competitor threat and disruption	Competitor threat and disruption	Capital management
7	Brand and reputation	Ethical culture	Brand and reputation	Globalisation	Global marketplace	Competitor threat
8	Future-ready workforce	Future-ready workforce	Ethical culture	Competition for capital	Ethical and transparent governance	Regulation
9	Data security and cyber safety	Globalisation	Competitor threat and disruption	Ethical culture	Competition for capital	Economic wellbeing
10	Human and labour rights	Human and labour rights	Partnerships and collaboration	Economic wellbeing	Individualism	Environmental impacts

Source: NZ Post, Forsyth Barr analysis

Figure 2. NZ Post's 2020 material matrix

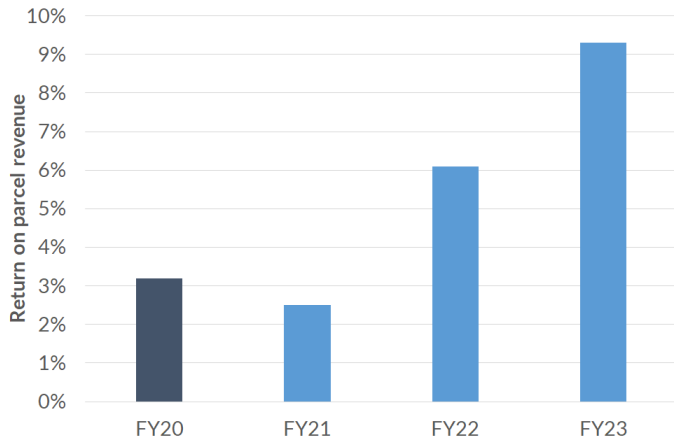


Source: NZ Post, Forsyth Barr analysis

Aggressive financial targets

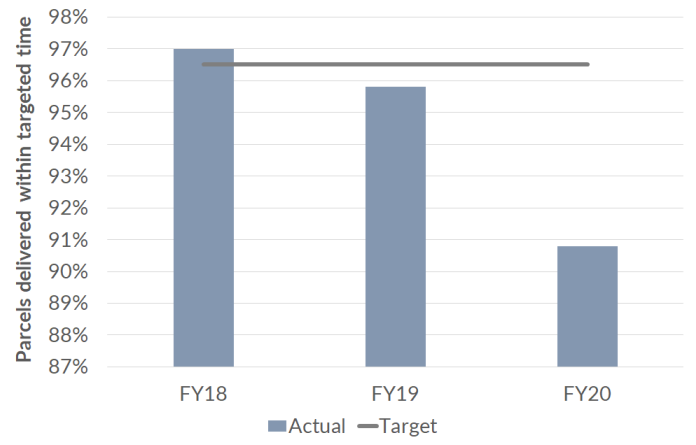
NZ Post has set new financial targets for its parcel operations based on a return on parcel revenue (EBIT margin) metric, which increases from 3.2% in FY20 to >9% in FY23. The margin increase based on FY20 revenue of almost NZ\$500m amounts to additional EBIT of ~NZ\$45m. We believe the margin decline targeted in FY21 reflects increased property costs associated with its significant multi-year footprint expansion and operational enhancements to cater for the delivery quality challenges (Figure 4), which were a function of COVID-19 and the surge in ecommerce activity. This was more of a challenge for NZ Post than other parcel market participants given its high exposure to the B2C channel. Over the first 10 days of Alert Level 3, parcel volumes were higher than its pre COVID-19 volumes by +150% every day and beat its previous record (Black Friday 2019) by +50%.

Figure 3. NZ Post's commercial performance targets for parcels

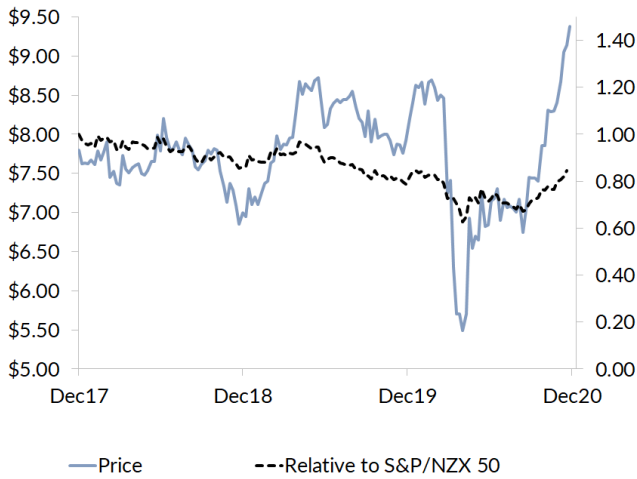


Source: NZ Post, Forsyth Barr analysis

Figure 4. NZ Post's delivery quality



Source: NZ Post, Forsyth Barr analysis

Figure 5. Price performance


Source: Forsyth Barr analysis

Figure 6. Substantial shareholders

Shareholder	Latest Holding
ANZ NZ Investments	6.5%
Investment Services Group	5.7%

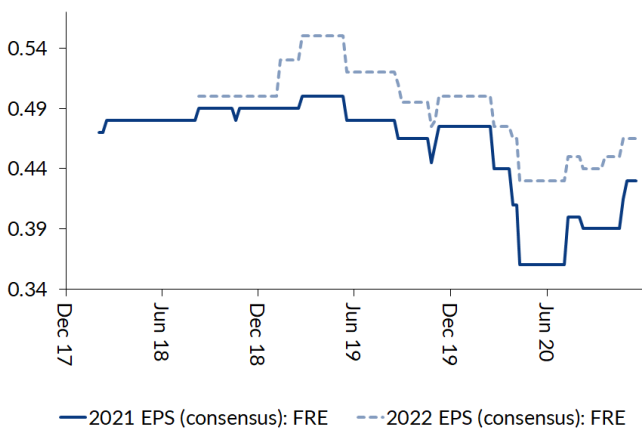
Source: NZX, Forsyth Barr analysis, NOTE: based on SPH notices only

Figure 7. International valuation comparisons

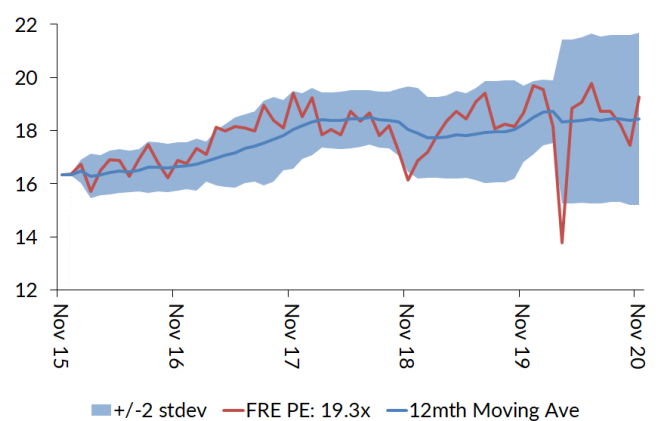
Company (metrics re-weighted to reflect FRE's balance date - June)	Code	Price	Mkt Cap (m)	PE		EV/EBITDA		EV/EBIT		Cash Yld 2022E
				2021E	2022E	2021E	2022E	2021E	2022E	
Freightways	FRE NZ	NZ\$9.38	NZ\$1,554	20.4x	17.9x	9.5x	9.0x	13.8x	12.7x	4.2%
MAINFREIGHT *	MFT NZ	NZ\$58.50	NZ\$5,891	31.5x	27.7x	12.9x	11.9x	20.7x	18.9x	1.4%
FEDEX CORP	FDX US	US\$276.69	US\$72,657	17.6x	15.9x	11.2x	10.3x	18.5x	16.7x	1.0%
UNITED PARCEL SERVICE-CL B	UPS US	US\$163.76	US\$141,554	20.4x	18.5x	14.4x	13.2x	19.1x	17.1x	2.6%
DEUTSCHE POST AG-REG	DPW GR	€39.83	€49,352	15.8x	14.4x	7.3x	6.9x	13.1x	11.7x	3.5%
ARAMEX PJSC	ARMX UH	AED3.95	AED5,783	18.5x	13.2x	6.8x	5.9x	9.9x	8.5x	4.3%
IRON MOUNTAIN INC	IRM US	US\$25.69	US\$7,403	18.9x	17.4x	12.3x	11.6x	23.5x	21.0x	9.7%
Compco Average:				20.4x	17.8x	10.8x	10.0x	17.5x	15.7x	3.8%
FRE Relative:				-0%	1%	-12%	-10%	-21%	-19%	11%

EV = Current Market Cap + Actual Net Debt

Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (FRE) companies fiscal year end

Figure 8. Consensus EPS momentum (NZ\$)


Source: Forsyth Barr analysis

Figure 9. One year forward PE (x)


Source: Forsyth Barr analysis

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