FORSYTH BARR

Mercury

NEUTRAL

Trading Gains — FY19 Result

Mercury (MCY) reported a strong FY19 EBITDAF result, which whilst down -11% on the pcp to $505m was ~+$10m better than could otherwise be expected. Both the result and FY20 guidance were in line with expectations; hence, we have made minimal forecast changes. However, we have increased our target price +27cps (+6.7%) to $4.30 as lower interest rates reduce return expectations.

What's changed?

- **Earnings:** FY20 EBITDAF increased +$2m to $488m
- **Target Price:** Increased +27cps (+6.7%) to $4.30
- **Rating:** NEUTRAL rating retained

Strong FY19 result meets expectations

MCY's FY19 result met expectations. Both EBITDAF ($505m) and Normalised NPAT ($161m) were within $1m of our forecast and the final, fully imputed dividend of 9.3cps was also consistent with guidance. The result was a strong one, as despite a material drop in hydro generation, MCY was able to produce an EBITDAF result ~+$10m higher than normalised hydrology earnings.

Earnings outlook also consistent with our forecast, although the mix is slightly different

MCY's FY20 EBITDAF guidance of $485m was just -$1m lower than our forecast heading into the result. However, MCY has indicated operating costs are going to be higher in FY20 than we had forecast, which partially offsets an improving outlook due to firm wholesale electricity prices. Our FY20 EBITDAF forecast has increased just +$2m to $488m.

Following the development of MCY's Turitea windfarm, we expect more material earnings increases, which MCY has confirmed should flow into increased dividends. We estimate that the Turitea project will be able to underwrite a ~+1.5cps increase in the ordinary dividend in FY22. If MCY has no calls on its capital at that time, we believe special dividends in the order of ~4.5cps could be forthcoming in addition to the ordinary dividend.

MCY focussing on margin, not retail connections

MCY has been the notable loser of customer connections in FY19, with connections down -15,000 — the most of any electricity retailer. MCY has deliberately chosen to reduce acquisition activity, as in its view retail margins are unattractive relative to commercial margins which are more closely linked to ASX futures prices. We expect further retail market share declines in FY20 to be offset by increases in commercial volumes.

Target price increase to $4.30

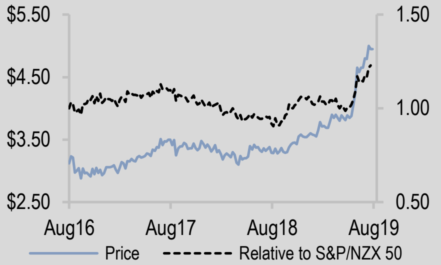
We have increased our target price +6.7% (+27cps) to $4.30. The main driver of the increase is a +12% increase in our DCF valuation following the lowering of our risk free rate assumption from 2.75% to 2.0%.

Investment View

Our rating is NEUTRAL. MCY is a strong operator in a stable sector and offers investors a reasonable dividend yield. Whilst the near-term interest rate outlook should be supportive for the share price, there is downside risk if interest rates rise. Overall, we see MCY as fairly valued.

NZX Code	MCY
Share price	NZ$4.95
Target price	NZ$4.30
Risk rating	Low
Issued shares	1360.9m
Market cap	NZ$6,736m
Average daily turnover	676.8k (NZ$2,526k)

Share Price Performance



Financials: June	19A	20E	21E	22E
NPAT* (NZ$m)	239.0	228.2	271.3	285.9
EPS* (NZc)	17.6	16.8	19.9	21.0
EPS growth* (%)	-6.4	-4.5	18.9	5.4
DPS (NZc)	15.5	15.8	16.2	22.1
Imputation (%)	100	100	100	85

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	15.1	15.5	14.6	13.9
EV/EBIT	25.3	26.4	24.1	22.4
PE	28.2	29.5	24.8	23.6
Price / NTA	1.9	2.0	2.0	n/a
Cash dividend yield (%)	3.1	3.2	3.3	4.5
Gross dividend yield (%)	4.3	4.4	4.5	5.9

*Historic and forecast numbers based on underlying profits

Andrew Harvey-Green
andrew.harvey-green@forsythbarr.co.nz
+64 4 495 8185

Mercury NZ Limited (MCY)		Priced as at 20 Aug 2019: NZ$4.95			June year end

Forsyth Barr valuation			
Valuation methodology		Mix of market multiple and DCF	
12-month target price (NZ$)*	**4.30**	**Spot valuations (NZ$)**	
Expected share price return	-13.1%	1. DCF	3.96
Net dividend yield	3.2%	2. Market multiple	4.76
Estimated 12-month return	-9.9%	3. Dividend yield	4.22
Key WACC assumptions		**DCF valuation summary (NZ$m)**	
Risk free rate	2.00%	Total firm value	6,490
Equity beta	0.88	(Net debt)/cash	(1,096)
WACC	6.7%	Value of equity	5,394
Terminal growth	1.5%	Shares (m)	1,361

Profit and Loss Account (NZ$m)	2018A	2019A	2020E	2021E	2022E
Sales revenue	1,798	2,000	1,818	1,784	1,766
Normalised EBITDA	**566**	**505**	**488**	**522**	**549**
Depreciation and amortisation	(201)	(204)	(205)	(208)	(212)
Normalised EBIT	**365**	**301**	**284**	**314**	**337**
Net interest	(91)	(75)	(66)	(70)	(72)
Associate income	2	1	3	3	3
Tax	(91)	(73)	(64)	(71)	(77)
Depreciation capex adj	58	78	71	95	95
Adjusted normalised NPAT	**256**	**239**	**228**	**271**	**286**
Abnormals/other	(7)	118	(71)	(95)	(95)
Reported NPAT	**249**	**357**	**157**	**176**	**191**
Normalised EPS (cps)	18.8	17.6	16.8	19.9	21.0
DPS (cps)	15.1	15.5	15.8	16.2	22.1

Growth Rates	2018A	2019A	2020E	2021E	2022E
Revenue (%)	12.6	11.2	-9.1	-1.9	-1.0
EBITDA (%)	8.2	-10.8	-3.3	6.9	5.0
EBIT (%)	7.9	-17.7	-4.9	10.5	7.2
Normalised NPAT (%)	1.8	-6.5	-4.5	18.9	5.4
Normalised EPS (%)	2.9	-6.4	-4.5	18.9	5.4
Ordinary DPS (%)	3.4	2.6	1.9	2.5	36.4

Cash Flow (NZ$m)	2018A	2019A	2020E	2021E	2022E
EBITDA	**566**	**505**	**488**	**522**	**549**
Working capital change	4	2	52	(63)	(2)
Interest & tax paid	(192)	(148)	(151)	(160)	(167)
Other	(4)	(33)	-	-	-
Operating cash flow	**374**	**326**	**390**	**299**	**381**
Capital expenditure	(127)	(122)	(301)	(111)	(80)
(Acquisitions)/divestments	(139)	215	-	-	-
Other	6	5	1	1	1
Funding available/(required)	**114**	**424**	**90**	**189**	**301**
Dividends paid	(273)	(208)	(212)	(218)	(225)
Equity raised/(returned)	(55)	7	-	-	-
Increase/(decrease) in net debt	**214**	**(223)**	**122**	**29**	**(76)**

Balance Sheet (NZ$m)	2018A	2019A	2020E	2021E	2022E
Working capital	63	63	11	73	75
Fixed assets	5,370	5,528	5,629	5,539	5,410
Intangibles	85	62	59	57	55
Other assets	385	521	523	526	529
Total funds employed	**5,903**	**6,174**	**6,223**	**6,195**	**6,069**
Net debt/(cash)	1,264	1,096	1,218	1,247	1,171
Other non current liabilities	1,306	1,498	1,480	1,464	1,448
Shareholder's funds	3,333	3,580	3,525	3,484	3,450
Minority interests	-	-	-	-	-
Total funding sources	**5,903**	**6,174**	**6,223**	**6,195**	**6,069**

Valuation Ratios	2018A	2019A	2020E	2021E	2022E
EV/EBITDA (x)	13.7	15.1	15.5	14.6	13.9
EV/EBIT (x)	21.1	25.3	26.4	24.1	22.4
PE (x)	26.4	28.2	29.5	24.8	23.6
Price/NTA (x)	2.1	1.9	2.0	2.0	2.0
Free cash flow yield (%)	3.7	3.0	1.3	2.8	4.5
Net dividend yield (%)	3.1	3.1	3.2	3.3	4.5
Gross dividend yield (%)	4.2	4.3	4.4	4.5	5.9
Imputation (%)	100	100	100	100	85
Pay-out ratio (%)	80	88	94	81	105

Capital Structure	2018A	2019A	2020E	2021E	2022E
Interest cover EBIT (x)	4.7	6.7	4.4	4.6	4.7
Interest cover EBITDA (x)	6.2	6.7	7.4	7.5	7.6
Net debt/ND+E (%)	27.8	23.7	25.9	26.6	25.6
Net debt/EBITDA (x)	2.2	2.2	2.5	2.4	2.1

Key Ratios	2018A	2019A	2020E	2021E	2022E
Return on assets (%)	7.1	7.8	4.4	4.9	5.4
Return on equity (%)	6.0	4.6	4.5	5.1	5.6
Return on funds employed (%)	5.8	4.7	4.3	4.8	5.3
EBITDA margin (%)	31.5	25.3	26.9	29.3	31.1
EBIT margin (%)	20.4	15.1	15.8	17.8	19.3
Capex to sales (%)	7.1	6.1	16.6	6.2	4.5
Capex to depreciation (%)	69	67	158	57	40

Operating Statistics	2018A	2019A	2020E	2021E	2022E
Hydro	4,947	4,006	3,980	4,016	4,016
Geothermal	2,757	2,894	2,810	2,829	2,829
Wind	-	-	-	181	469
Total MCY Generation (GWh)	**7,704**	**6,900**	**6,790**	**7,026**	**7,314**
GWAP ($/MWh)	86.3	138.7	114.6	105.2	98.4
Electricity customers (000)	388	373	364	360	357
MM volumes	3,278	3,182	3,009	2,969	2,945
TOU volumes	1,200	1,319	1,385	1,421	1,428
Total Fixed Price volumes (GWh)	**4,478**	**4,501**	**4,393**	**4,390**	**4,373**
Spot Sales	891	780	731	734	738
Net CFD's	2,110	1,624	1,563	1,563	1,563
Total Sales (GWh)	**7,479**	**6,905**	**6,687**	**6,687**	**6,674**
Average usage per cust (MWh/yr)	11.4	11.8	12.0	12.1	12.2
LWAP ($/MWh)	91.6	144.2	120.5	111.0	104.1
LWAP/GWAP	1.06	1.04	1.05	1.06	1.06
Average FPVV price ($/MWh)	112.5	113.4	115.1	117.7	119.8
Line losses (%)	5.6	5.1	5.4	5.3	5.3
Retail gas customers (000)	48	47	46	46	47
Retail gas volumes (PJ)	1.1	1.1	1.0	1.0	1.0
Gas volume/cust (GJ/yr)	22.5	22.5	22.5	22.5	22.5
Energy margin ($m)	730	667	672	704	737
Operating costs ($m)	(205)	(199)	(203)	(202)	(208)
Other revenue ($m)	41	37	19	20	20
MCY EBITDAF ($m)	**566**	**505**	**488**	**522**	**549**

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

FY19 result summary

Figure 1. FY19 result summary

	FY18 $m	FY19 $m	% Chg	FB $m	Diff $m	Commentary
Sales revenue	1,751	1,957	12%	1,972	(15)	Increase vs. pcp due to high wholesale electricity prices
Cost of sales	(1,027)	(1,296)	26%	(1,301)	5	
Energy margin	**724**	**661**	-9%	**670**	**(9)**	Lower generation volumes reduced Energy Margin vs. pcp
Other revenue	47	43	-9%	34	9	
Other operating costs	(205)	(199)	-3%	(200)	1	
EBITDAF	**566**	**505**	-11%	**504**	**1**	In line with expectations, +$10m higher than latest guidance
Depn & amort	(201)	(204)	1%	(200)	(4)	
FV mvmts, assoc inc, other	66	204	209%	179	25	Big gain ($177m) from sale of Metrix
EBIT	**431**	**505**	17%	**482**	**23**	
Net interest	(91)	(75)	-18%	(78)	3	Lower interest costs due to high cost debt rolling off in pcp
Pre-tax profit	**340**	**430**	26%	**404**	**26**	
Tax	(91)	(73)	-20%	(61)	(12)	
NPAT	**249**	**357**	43%	**343**	**14**	
Normalised NPAT	**198**	**161**	-19%	**162**	**(1)**	Normalised NPAT in line with expectations
EPS (cps)	14.5	11.8	-19%	11.9	(0.1)	
FY dividend (cps)	15.1	15.5	3%	15.5	0.0	Fully imputed dividend consistent with MCY guidance
Final dividend (cps)	9.1	9.3	2%	9.3	0.0	
Operating statistics						
Generation (GWh)	7,704	6,900	-10%	6,900	0.0	Big drop in hydro generation to normal levels. Strong geothermal generation
FPVV sales (GWh)	4,478	4,501	1%	4,501	0.0	Lift in sales from commercial volumes. Mass market volumes declined
Customer numbers	388,000	373,000	-4%	373,000	0.0	
GWAP ($/MWh)	$86.3	$138.7	61%	$138.7	0.0	Very high wholesale prices in FY19 due to gas market issues
LWAP/GWAP	1.06	1.04	-2%	1.04	0.0	Improved ratio due to lower hydro generation

Source: MCY, Forsyth Barr analysis

Key points from the FY19 result:

- FY19 was a strong result in the context of average hydro generation. Strong wholesale prices and enough water at the right time enabled MCY to produce a result ~+$10m more than underlying normalised hydro EBITDAF
- The result contained few surprises and the key metrics of EBITDAF, Normalised NPAT and dividend were all in line with expectations
- Whilst MCY shed -15,000 connections during FY19, it has shifted sales volumes into the commercial market where margins are more attractive at present. Therefore, the drop in connections should not negatively impact future profitability
- MCY repaid $215m of debt in FY19 following the sale of its Metrix metering business. Looking ahead, debt will increase in FY20 and FY21 as MCY completes its Turitea wind farm, but debt metrics will remain benign
- MCY has guided to FY20 EBITDAF of $485m, and a dividend of 15.8cps consistent with our expectations heading into the result. Whilst high wholesale electricity prices are a key driver of MCY indicating underlying EBITDAF growth has increased +$15m, opex is up +$5m (associated with geothermal and hydro maintenance programs)
- MCY is continuing to benefit from falling interest rates and it has indicated interest costs in FY20 should be ~-$10m lower than FY19
- Investors can expect an increase in the ordinary dividend greater than inflation following the commissioning of Turitea in FY21. We expect MCY can lift the ordinary dividend +1.5cps following Turitea commissioning, with underlying free cash flow supporting a dividend of ~22.1cps in FY22 (assuming there are no other calls on MCY's capital)

Forecast and valuation changes

We have lifted our FY20 EBITDAF forecast slightly (+$2m) to $488m as the wholesale electricity price outlook has again firmed in recent weeks. However, within EBITDAF, we are assuming higher operating costs (we had previously assumed further cost out from MCY in FY20), which largely offsets the wholesale price upside.

In addition, maintenance capex guidance is higher than previously anticipated as MCY is undertaking a geothermal drilling campaign in FY20. We have increased our maintenance capex forecast +$33m.

Figure 2. Forecast changes

	FY20 Old $m	FY20 New $m	% Chg	FY21 Old $m	FY21 New $m	% Chg	FY22 Old $m	FY22 New $m	% Chg
Sales revenue	1,775	1,796	1%	1,783	1,762	-1%	1,817	1,743	-4%
Cost of sales	(1,114)	(1,124)	1%	(1,095)	(1,058)	-3%	(1,085)	(1,006)	-7%
Energy margin	**661**	**672**	**2%**	**689**	**704**	**2%**	**733**	**737**	**1%**
Other income	17	19	12%	18	20	12%	18	20	12%
Other operating costs	(191)	(203)	6%	(196)	(202)	3%	(203)	(208)	3%
EBITDAF	**486**	**488**	**0%**	**510**	**522**	**2%**	**547**	**549**	**0%**
Depn & amort	(191)	(205)	7%	(190)	(208)	10%	(199)	(212)	7%
FV mvmts, assoc inc, other	3	3	0%	3	3	-1%	11	11	0%
EBIT	**299**	**287**	**-4%**	**324**	**317**	**-2%**	**360**	**348**	**-3%**
Net interest	(68)	(66)	-3%	(71)	(70)	-2%	(78)	(72)	-8%
Pre-tax profit	**231**	**221**	**-4%**	**252**	**248**	**-2%**	**282**	**276**	**-2%**
Tax	(67)	(64)	-4%	(73)	(71)	-2%	(79)	(77)	-2%
NPAT	**164**	**157**	**-4%**	**180**	**176**	**-2%**	**203**	**199**	**-2%**
Dividend (cps) (incl specials)	15.9	15.8	-1%	16.1	16.2	1%	21.5	22.1	3%
Operating statistics			**Diff**			**Diff**			**Diff**
Generation (GWh)	6,834	6,790	-0.6%	7,044	7,026	-0.2%	7,332	7,314	-0.2%
FPVV sales (GWh)	4,491	4,393	-2.2%	4,474	4,390	-1.9%	4,456	4,373	-1.9%
Customer numbers (000)	369.3	363.7	-1.5%	365.6	360.1	-1.5%	361.9	356.5	-1.5%
GWAP ($/MWh)	$101.8	$114.6	12.6%	$96.7	$105.2	8.8%	$92.9	$98.4	5.9%
LWAP/GWAP	1.051	1.051	0.0%	1.055	1.055	0.0%	1.060	1.058	-0.1%

Source: Forsyth Barr analysis

The change to our WACC assumptions (the main change is lowering our risk free rate assumption to 2.0% from 2.75%) has resulted in a +12% increase in our DCF to $3.96. We have also increased our target price +27cps (+6.7%) to $4.30.

Investment summary

Our rating is NEUTRAL. Mercury (MCY) is a strong operator in a stable sector and offers investors a reasonable dividend yield. Whilst the near-term interest rate outlook should be supportive for the share price, there is downside risk if interest rates rise. Overall, we see MCY as fairly valued.

Business quality

- **Low risk, modest growth industry:** Electricity demand is relatively inelastic and is expected to grow slowly in the future. The industry is well positioned to benefit from New Zealand decarbonising transport and industrial processes.
- **Strong generation position:** Most of the value within the electricity sector lies within the generation assets. MCY is the largest North Island generator and its hydro generation is particularly suited to meeting electricity demand peaks.
- **Track record:** MCY has a strong development track record, having built a geothermal generation portfolio in the past 15 years and is now expanding into wind development.

Earnings and cash flow outlook

- **Earnings growth after FY20:** MCY's move into a development phase will drive earnings growth after FY20. The new wind farm development at Turitea is likely to add ~$30m (~+6%) per annum to underlying EBITDAF.
- **Operating cash flow strong but development restarting:** MCY has a strong track record of returning surplus cash to shareholders; however, with new generation under development, capital returns over and above the ordinary dividend are less likely.

Financial structure

- **Balance sheet:** MCY's balance sheet has reasonable headroom (particularly after including treasury shares acquired in past buy-backs). Its recent investment in Tilt Renewables (TLT) and the decision to build new generation means there is no surplus capital for the next few years.

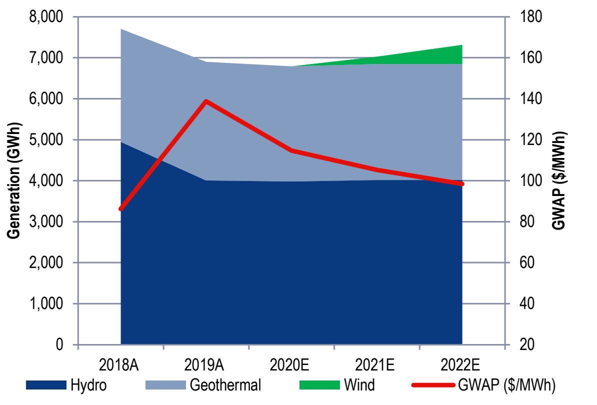
Key risks

- **Regulatory risk:** Whilst the Electricity Price Review creates some uncertainty, we believe there is as much upside as downside risk, and in any case is unlikely to have a material impact on MCY.
- **Rising bond yields:** In recent years MCY has traded in line with bond yields. A lift in interest rates is likely to see MCY trade lower, although in our view interest rates are likely to remain low for the foreseeable future.

Company description

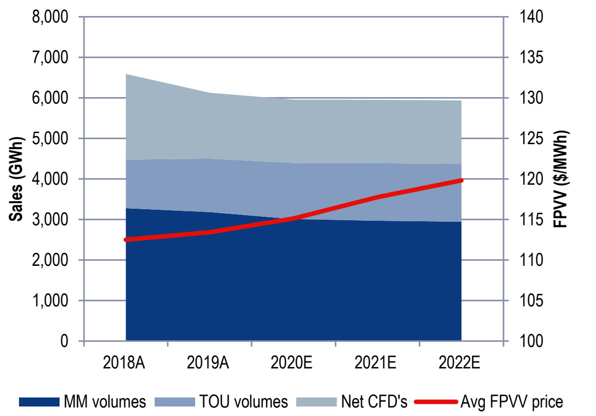
MCY is one of New Zealand's large electricity generator/retailers. It is a 100% renewable generator producing ~6,800GWh of electricity from its North Island based Waikato River hydro power station and geothermal power stations. MCY is developing its first wind farm which is expected to produce ~470GWh per annum and be commissioned in FY21. Its retail brands, Mercury, Bosco Connect, GLOBUG and Tiny Mighty Power retail electricity and gas to around 430,000 customers. GLOBUG is an innovative prepay product. MCY also owns 20% of Tilt Renewables (TLT) and a small solar installation business.

Figure 3. Generation volumes and GWAP



Source: MCY, Forsyth Barr analysis

Figure 4. Sales volumes and average sales price



Source: MCY, Forsyth Barr analysis

Figure 5. Substantial Shareholders

Shareholder	Latest Holding
NZ Govt	52.6%

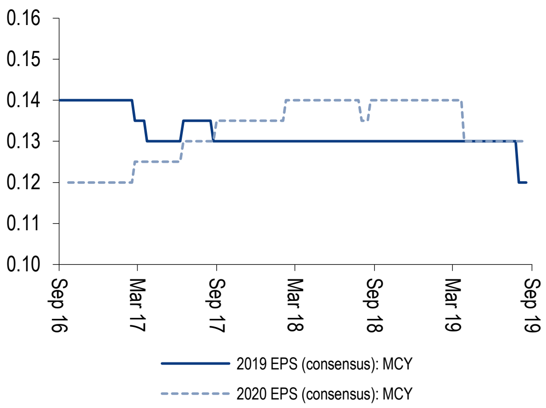
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 6. International Compcos

Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash D/Yld
(metrics re-weighted to reflect MCY's balance date - June)			(m)	2020E	2021E	2020E	2021E	2020E	2021E	2021E
Mercury	**MCY NZ**	**NZ$4.95**	**NZ$6,736**	**29.5x**	**24.8x**	**16.0x**	**15.0x**	**27.3x**	**24.7x**	**3.3%**
Contact Energy *	CEN NZ	NZ$8.44	NZ$6,050	22.8x	22.8x	14.3x	14.3x	24.4x	24.1x	4.7%
Genesis Energy *	GNE NZ	NZ$3.26	NZ$3,332	20.1x	18.9x	12.4x	12.4x	27.4x	26.7x	5.4%
Meridian Energy *	MEL NZ	NZ$4.67	NZ$11,969	24.8x	27.5x	16.1x	17.6x	24.0x	27.3x	4.5%
Trustpower *	TPW NZ	NZ$7.62	NZ$2,385	22.6x	22.1x	14.0x	13.7x	17.6x	17.1x	4.6%
AGL Energy	AGL AT	A$18.92	A$12,408	14.8x	14.7x	7.2x	7.2x	11.1x	11.4x	5.2%
ERM Power	EPW AT	A$1.70	A$425	11.0x	8.6x	4.0x	3.7x	5.9x	5.4x	6.7%
Origin Energy	ORG AT	A$7.14	A$12,575	12.2x	11.6x	7.9x	8.0x	14.2x	14.2x	4.7%
			Compco Average:	**18.3x**	**18.0x**	**10.8x**	**11.0x**	**17.8x**	**18.0x**	**5.1%**
EV = Current Market Cap + Actual Net Debt			**MCY Relative:**	**+61%**	**+38%**	**+48%**	**+37%**	**+53%**	**+37%**	**-36%**

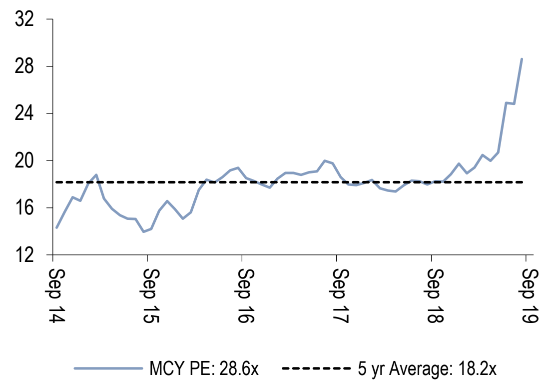
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (MCY) companies fiscal year end

Figure 7. Consensus EPS Momentum



Source: Forsyth Barr analysis, Bloomberg

Figure 8. 12 Month Forward PE



Source: Forsyth Barr analysis