

# Mercury

**UNDERPERFORM**

## Upgrading Early in FY20 — 1Q20 Operating Statistics

Mercury (MCY) has had a strong 1Q20 and the outlook is positive for the remainder of FY20, such that it has lifted FY20 EBITDAF guidance +\$25m to \$510m. We have lifted our FY20 EBITDAF forecast +\$26m to \$514m, with the main drivers of the upgrade being strong wholesale electricity prices and a return to above average hydrology (albeit only slightly).

### What's changed?

- **Earnings:** FY20 EBITDAF increased +\$26m (+5.3%) to \$514m
- **Target Price:** Increased +10cps (+2.2%)
- **Rating:** UNDERPERFORM rating retained

### Powering ahead into FY20

Three factors stood out in 1Q20, enabling MCY to lift its FY20 EBITDAF guidance +\$25m. First, hydro generation was above average for the first time since 1Q19, and current lake levels are also above average for the first time in a year. This has enabled MCY to lift its FY20 hydro generation guidance to +50GWh above normal. Second, high ASX future prices are remaining high and that is now flowing through into MCY's reported commercial and industrial prices, which were up +6.7% in 1Q20 vs. pcp (compared with less than +2% in previous quarters). Third, MCY has dropped a significant number of dairy connections (total electricity connection numbers fell -12,000 in 1Q20, the biggest ever quarterly decline). With wholesale electricity prices averaging over \$115/MWh in 1Q20, and expected to stay higher for longer, this provides MCY with extra margin (i.e. generation volumes that were previously sold to the dairy sector can now be sold on the spot electricity market at a higher margin).

### Forecast changes limited to FY20 and FY21

We have increased our FY20 EBITDAF forecast +\$26m to \$514m and our FY21 EBITDAF forecast +\$6m to \$528m. The assumed wholesale electricity price increase is more material in FY20 (up +12%) and is only up +3% in FY21 and less than +1% in FY22. In our view wholesale electricity prices are unsustainably high, above \$100/MWh, given the cost of building new generation (after adjusting for wind discount factors) is below \$80/MWh. We, therefore, expect wholesale prices to fall in due course, although that may be a couple of years away. This is also the reason why our FY22 EBITDAF forecast is effectively unchanged.

The +10cps increase in our target price to \$4.55 reflects the near-term earnings increases and a recent increase in our Tilt Renewables (TLT) valuation.

### MSCI Index inclusion looking likely

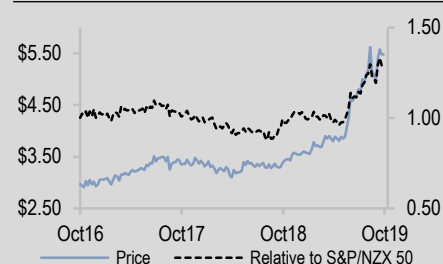
Our analysis indicates that on Friday 8 November, it will be announced that MCY will enter the MSCI New Zealand Standard Index.

### Investment View

Our rating is UNDERPERFORM. MCY is a quality company with some near-term earnings growth from its wind farm development and more favourable wholesale electricity market conditions. However, in our view MCY is now expensive and the expected returns do not justify the risk.

NZX Code	MCY
Share price	NZ\$5.48
Target price	NZ\$4.55
Risk rating	Low
Issued shares	1360.9m
Market cap	NZ\$7,458m
Average daily turnover	677.1k (NZ\$2,832k)

### Share Price Performance



Financials: June	19A	20E	21E	22E
NPAT* (NZ\$m)	239.0	246.5	276.1	287.1
EPS* (NZc)	17.6	18.1	20.3	21.1
EPS growth* (%)	-6.4	3.1	12.0	4.0
DPS (NZc)	15.5	15.8	16.2	22.1
Imputation (%)	100	100	100	85

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	16.6	16.1	15.8	15.2
EV/EBIT	27.7	26.5	25.8	24.5
PE	31.2	30.3	27.0	26.0
Price / NTA	2.1	2.2	2.2	n/a
Cash dividend yield (%)	2.8	2.9	3.0	4.0
Gross dividend yield (%)	3.9	4.0	4.1	5.4

\*Historic and forecast numbers based on underlying profits

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Mercury NZ Limited (MCY)					Priced as at 18 Oct 2019: NZ\$5.48					June year end					
Forsyth Barr valuation					Valuation Ratios					2018A	2019A	2020E	2021E	2022E	
Valuation methodology					Mix of market multiple and DCF					EV/EBITDA (x)	14.9	16.6	16.1	15.8	15.2
										EV/EBIT (x)	23.0	27.7	26.5	25.8	24.5
12-month target price (NZ\$)*	4.55	Spot valuations (NZ\$)				PE (x)	29.2	31.2	30.3	27.0	26.0				
Expected share price return	-17.0%	1. DCF		4.15		Price/NTA (x)	2.3	2.1	2.2	2.2	2.2				
Net dividend yield	2.9%	2. Market multiple		5.04		Free cash flow yield (%)	3.3	2.7	1.4	2.6	4.0				
Estimated 12-month return	-14.1%	3. Dividend yield		4.52		Net dividend yield (%)	2.8	2.8	2.9	3.0	4.0				
										Gross dividend yield (%)	3.8	3.9	4.0	4.1	5.4
Key WACC assumptions					DCF valuation summary (NZ\$m)					Imputation (%)	100	100	100	100	85
Risk free rate	2.00%	Total firm value		6,873		Pay-out ratio (%)	80	88	87	80	105				
Equity beta	0.88	(Net debt)/cash		(1,223)											
WACC	6.6%	Value of equity		5,651		Capital Structure	2018A	2019A	2020E	2021E	2022E				
Terminal growth	1.5%	Shares (m)		1,361		Interest cover EBIT (x)	4.7	6.7	4.7	4.7	4.8				
										Interest cover EBITDA (x)	6.2	6.7	7.8	7.7	7.8
Profit and Loss Account (NZ\$m)	2018A	2019A	2020E	2021E	2022E	Net debt/ND+E (%)	27.8	23.7	25.5	26.1	25.1				
Sales revenue	1,798	2,000	1,943	1,830	1,793	Net debt/EBITDA (x)	2.2	2.2	2.3	2.3	2.1				
Normalised EBITDA	566	505	514	528	549										
Depreciation and amortisation	(201)	(204)	(205)	(208)	(212)	Key Ratios	2018A	2019A	2020E	2021E	2022E				
Normalised EBIT	365	301	309	320	337	Return on assets (%)	7.1	7.8	4.7	5.0	5.4				
Net interest	(91)	(75)	(66)	(69)	(71)	Return on equity (%)	6.0	4.6	5.0	5.2	5.6				
Associate income	2	1	3	3	3	Return on funds employed (%)	5.8	4.7	4.7	4.9	5.3				
Tax	(91)	(73)	(71)	(73)	(78)	EBITDA margin (%)	31.5	25.3	26.4	28.8	30.6				
Depreciation capex adj	58	78	71	95	95	EBIT margin (%)	20.4	15.1	16.1	17.6	19.0				
Adjusted normalised NPAT	256	239	247	276	287	Capex to sales (%)	7.1	6.1	15.5	6.1	4.5				
Abnormals/other	(7)	118	(71)	(95)	(95)	Capex to depreciation (%)	69	67	158	57	40				
Reported NPAT	249	357	176	181	192										
Normalised EPS (cps)	18.8	17.6	18.1	20.3	21.1	Operating Statistics	2018A	2019A	2020E	2021E	2022E				
DPS (cps)	15.1	15.5	15.8	16.2	22.1	Hydro	4,947	4,006	4,088	4,016	4,016				
										Geothermal	2,757	2,894	2,810	2,829	2,829
Growth Rates	2018A	2019A	2020E	2021E	2022E	Wind	-	-	-	181	469				
Revenue (%)	12.6	11.2	-2.8	-5.8	-2.1	Total MCY Generation (GWh)	7,704	6,900	6,898	7,026	7,314				
EBITDA (%)	8.2	-10.8	1.7	2.7	4.0	GWAP (\$/MWh)	86.3	138.7	128.5	108.2	99.0				
EBIT (%)	7.9	-17.7	3.5	3.3	5.5										
Normalised NPAT (%)	1.8	-6.5	3.1	12.0	4.0	Electricity customers (000)	388	373	354	351	347				
Normalised EPS (%)	2.9	-6.4	3.1	12.0	4.0	MM volumes	3,278	3,182	2,972	2,908	2,885				
Ordinary DPS (%)	3.4	2.6	1.9	2.5	36.4	TOU volumes	1,200	1,319	1,526	1,616	1,624				
										Total Fixed Price volumes (GWh)	4,478	4,501	4,498	4,524	4,509
Cash Flow (NZ\$m)	2018A	2019A	2020E	2021E	2022E	Spot Sales	891	780	731	734	738				
EBITDA	566	505	514	528	549	Net CFD's	2,110	1,624	1,563	1,563	1,563				
Working capital change	4	2	52	(62)	(3)	Total Sales (GWh)	7,479	6,905	6,791	6,821	6,810				
Interest & tax paid	(192)	(148)	(158)	(161)	(166)	Average usage per cust (MWh/yr)	11.4	11.8	12.5	12.8	12.9				
Other	(4)	(33)	-	-	-	LWAP (\$/MWh)	91.6	144.2	134.7	113.6	104.3				
Operating cash flow	374	326	408	305	381	LWAP/GWAP	1.06	1.04	1.05	1.05	1.05				
Capital expenditure	(127)	(122)	(301)	(111)	(80)	Average FPVV price (\$/MWh)	112.5	113.4	114.3	116.4	118.4				
(Acquisitions)/divestments	(139)	215	-	-	-	Line losses (%)	5.6	5.1	5.4	5.3	5.3				
Other	6	5	1	1	1	Retail gas customers (000)	48	47	46	46	47				
Funding available/(required)	114	424	108	195	301	Retail gas volumes (PJ)	1.1	1.1	1.0	1.0	1.0				
Dividends paid	(273)	(208)	(212)	(218)	(225)	Gas volume/cust (GJ/yr)	22.5	22.5	22.5	22.5	22.5				
Equity raised/(returned)	(55)	7	-	-	-										
Increase/(decrease) in net debt	214	(223)	104	23	(76)										
Balance Sheet (NZ\$m)	2018A	2019A	2020E	2021E	2022E	Energy margin (\$m)	730	667	698	710	738				
Working capital	63	63	11	73	75	Operating costs (\$m)	(205)	(199)	(203)	(202)	(208)				
Fixed assets	5,370	5,528	5,629	5,539	5,410	Other revenue (\$m)	41	37	19	20	20				
Intangibles	85	62	59	57	55	MCY EBITDAF (\$m)	566	505	514	528	549				
Other assets	385	521	523	526	529										
Total funds employed	5,903	6,174	6,223	6,194	6,069										
Net debt/(cash)	1,264	1,096	1,200	1,224	1,147										
Other non current liabilities	1,306	1,498	1,480	1,464	1,448										
Shareholder's funds	3,333	3,580	3,543	3,507	3,474										
Minority interests	-	-	-	-	-										
Total funding sources	5,903	6,174	6,223	6,194	6,069										

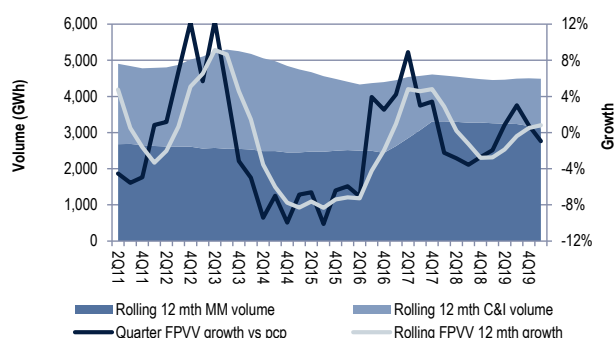
# 1Q20 operating statistics

Figure 1. 1Q20 operating statistics

	Sep-18 1Q19	Sep-19 1Q20	% Chg	Comments
<b>Fixed price, variable volume (FPVV) retail sales (GWh)</b>				
Mass market (MM)	955	892	-6.6%	Decline due mainly to lower connection numbers - many dairy related
Commercial & industrial (C&I)	297	348	17.2%	MCY continues to be active in the commercial market
<b>Total FPVV sales</b>	<b>1,252</b>	<b>1,240</b>	<b>-1.0%</b>	
End user CFDs	291	323	11.0%	
<b>Total FPVV and end user CFDs</b>	<b>1,543</b>	<b>1,563</b>	<b>1.3%</b>	
Customer numbers	386,000	361,000	-6.5%	Big step down in connections following loss of dairy related contracts
Customer losses during the quarter	(2,000)	(12,000)		Largest quarterly loss of connections
MM volume/customer (MWh/cust.)	2.47	2.43	-1.5%	
MM price (\$/MWh)	127.0	128.8	1.4%	Modest price increase, linked to fewer dairy connections
C&I price (\$/MWh)	82.8	88.3	6.7%	Strong price increase as firm ASX prices start to feed into higher C&I prices
<b>FPVV sales price</b>	<b>116.5</b>	<b>117.4</b>	<b>0.8%</b>	
LWAP (\$/MWh)	91.5	128.1	39.9%	
<b>Generation (GWh)</b>				
Hydro	1,446	1,214	-16.0%	Hydro generation lapping a very strong 1Q19
Geothermal	733	736	0.4%	Solid geothermal generation
<b>Total</b>	<b>2,179</b>	<b>1,950</b>	<b>-10.5%</b>	
Hydro diff to average	256	24		Slightly above avg hydro generation, plus lake levels ~+70GWh above avg at present
GWAP (\$/MWh)	86.0	123.1	43.1%	Strong wholesale prices have persisted and are a key reason for MCY's upgrade
LWAP/GWAP	1.066	1.041	-2.3%	Better LWAP/GWAP ratio vs. pcg, and slightly better than long-term expectations

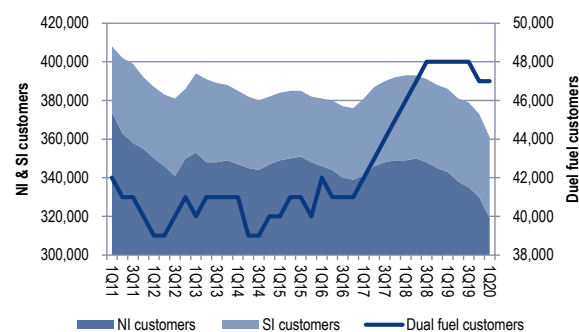
Source: MCY, Forsyth Barr analysis

Figure 2. Rolling 12-month sales volumes



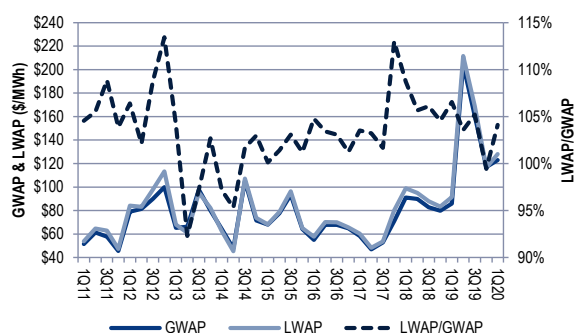
Source: MCY, Forsyth Barr analysis

Figure 3. Connection numbers



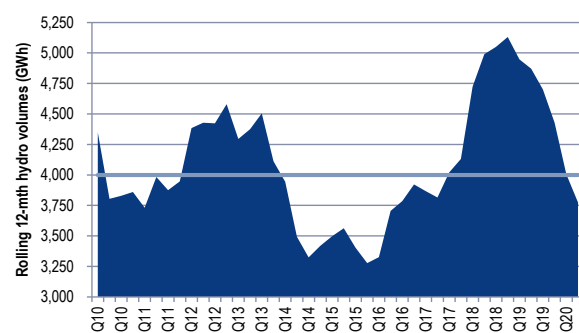
Source: MCY, Forsyth Barr analysis

Figure 4. LWAP/GWAP



Source: MCY, Forsyth Barr analysis

Figure 5. Rolling 12-month hydro generation



Source: MCY, Forsyth Barr analysis

## Forecast changes

Figure 6. Forecast changes

	FY20	FY20		FY21	FY21		FY22	FY22	
	Old	New		Old	New		Old	New	
	\$m	\$m	% Chg	\$m	\$m	% Chg	\$m	\$m	% Chg
Sales revenue	1,796	1,921	7%	1,762	1,808	3%	1,743	1,770	2%
Cost of sales	(1,124)	(1,224)	9%	(1,058)	(1,098)	4%	(1,006)	(1,032)	3%
<b>Energy margin</b>	<b>672</b>	<b>698</b>	<b>4%</b>	<b>704</b>	<b>710</b>	<b>1%</b>	<b>737</b>	<b>738</b>	<b>0%</b>
Other income	19	19	0%	20	20	0%	20	20	0%
Other operating costs	(203)	(203)	0%	(202)	(202)	0%	(208)	(208)	0%
<b>EBITDAF</b>	<b>488</b>	<b>514</b>	<b>5%</b>	<b>522</b>	<b>528</b>	<b>1%</b>	<b>549</b>	<b>549</b>	<b>0%</b>
Depn & amort	(205)	(205)	0%	(208)	(208)	0%	(212)	(212)	0%
FV mvmts, assoc inc, other	3	3	1%	3	3	1%	11	11	0%
<b>EBIT</b>	<b>287</b>	<b>313</b>	<b>9%</b>	<b>317</b>	<b>323</b>	<b>2%</b>	<b>348</b>	<b>349</b>	<b>0%</b>
Net interest	(66)	(66)	0%	(70)	(69)	-1%	(72)	(71)	-2%
<b>Pre-tax profit</b>	<b>221</b>	<b>247</b>	<b>11%</b>	<b>248</b>	<b>254</b>	<b>3%</b>	<b>276</b>	<b>278</b>	<b>1%</b>
Tax	(64)	(71)	11%	(71)	(73)	3%	(77)	(78)	1%
<b>NPAT</b>	<b>157</b>	<b>176</b>	<b>12%</b>	<b>176</b>	<b>181</b>	<b>3%</b>	<b>199</b>	<b>200</b>	<b>1%</b>
Dividend (cps) (incl specials)	15.8	15.8	0%	16.2	16.2	0%	22.1	22.1	0%
<b>Operating statistics</b>			<b>Diff</b>			<b>Diff</b>			<b>Diff</b>
Generation (GWh)	6,790	6,898	1.6%	7,026	7,026	0.0%	7,314	7,314	0.0%
FPVV sales (GWh)	4,393	4,498	2.4%	4,390	4,524	3.1%	4,373	4,509	3.1%
Customer numbers (000)	363.7	354.5	-2.5%	360.1	351.0	-2.5%	356.5	347.5	-2.5%
GWAP (\$/MWh)	\$114.6	\$128.5	12.1%	\$105.2	\$108.2	2.8%	\$98.4	\$99.0	0.6%
LWAP/GWAP	1.051	1.048	-0.3%	1.055	1.050	-0.5%	1.058	1.054	-0.4%

Source: MCY, Forsyth Barr analysis

## Investment summary

Our rating is **UNDERPERFORM**. MCY is a quality company with some near-term earnings growth from its wind farm development and more favourable wholesale electricity market conditions. However, in our view MCY is now expensive and the expected returns do not justify the risk.

### 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.

### 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.

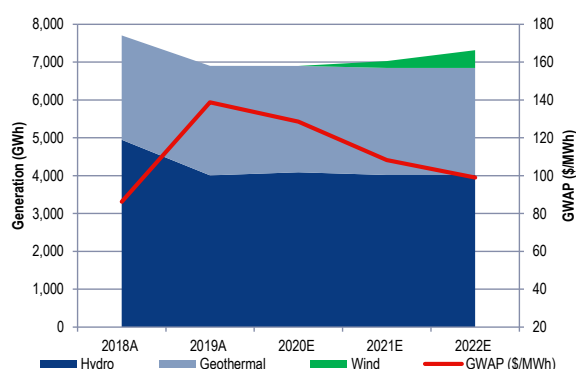
### Financial structure

- **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

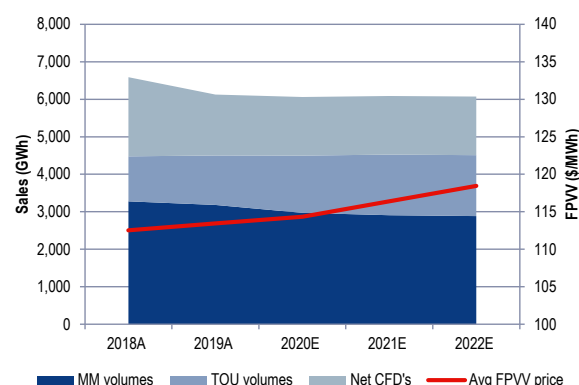
- **Regulatory risk:** Whilst the Electricity Price Review creates some uncertainty, we believe there is as much upside as downside risk, and in any case is unlikely to have a material impact on MCY.
- **Rising bond yields:** In recent years MCY has traded in line with bond yields. A lift in interest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

Figure 7. Generation volumes and average price received



Source: MCY, Forsyth Barr analysis

Figure 8. Sales volumes and average selling price



Source: MCY, Forsyth Barr analysis

**Figure 9. Substantial Shareholders**

Shareholder	Latest Holding
NZ Govt	52.6%

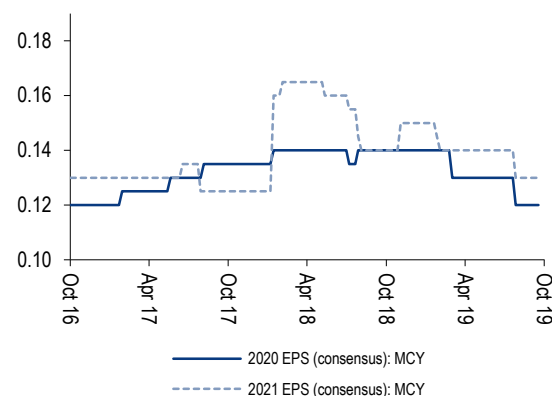
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

**Figure 10. International Compcos**

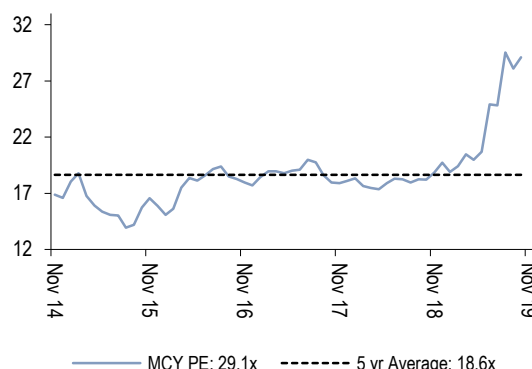
Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash D/Yld	
(metrics re-weighted to reflect MCY's balance date - June)			(m)	2020E	2021E	2020E	2021E	2020E	2021E	2021E	
Mercury	MCY NZ	NZ\$5.48	NZ\$7,458	30.3x	27.0x	16.7x	16.2x	27.4x	26.5x	3.0%	
Contact Energy *	CEN NZ	NZ\$8.55	NZ\$6,137	24.6x	23.1x	15.2x	14.4x	26.7x	24.4x	4.6%	
Genesis Energy *	GNE NZ	NZ\$3.40	NZ\$3,480	22.1x	17.9x	12.7x	11.5x	29.8x	24.2x	5.2%	
Meridian Energy *	MEL NZ	NZ\$5.40	NZ\$13,840	28.9x	31.5x	18.6x	19.8x	29.9x	32.7x	4.0%	
Trustpower *	TPW NZ	NZ\$8.48	NZ\$2,654	25.2x	24.6x	15.3x	14.9x	19.2x	18.7x	4.2%	
AGL Energy	AGL AT	A\$19.34	A\$12,637	15.0x	15.1x	7.3x	7.3x	11.2x	11.4x	5.1%	
ERM Power	EPW AT	A\$2.40	A\$601	12.0x	16.1x	7.1x	6.7x	10.1x	9.5x	4.2%	
Origin Energy	ORG AT	A\$8.06	A\$14,195	13.7x	12.9x	6.3x	6.2x	15.1x	14.7x	4.6%	
Compco Average:				20.2x	20.2x	11.8x	11.5x	20.3x	19.3x	4.5%	
EV = Current Market Cap + Actual Net Debt				MCY Relative:	+50%	+34%	+41%	+40%	+35%	+37%	-35%

EV = Current Market Cap + Actual Net Debt

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

**Figure 11. Consensus EPS Momentum**


Source: Forsyth Barr analysis, Bloomberg

**Figure 12. 12 Month Forward PE**


Source: Forsyth Barr analysis

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