

# Mercury

NEUTRAL

## NZAS Collateral Damage

We are upgrading our Mercury (MCY) rating to NEUTRAL due to, in our view, the overreaction of the market following the announcement that NZAS is undergoing a strategic review. MCY will be one of the least affected generator/retailers as all of its generation and most of its electricity customers are North Island based.

### What's changed?

- **Earnings:** FY20/FY21 EBITDAF +\$2m/-3m to \$516m and \$525m
- **Target Price:** Reduced -2cps (-0.4%) to \$4.53
- **Rating:** Upgraded to NEUTRAL

### NZAS closure risk minimal for MCY

MCY's exposure to NZAS is limited. Whilst it will be impacted by a temporarily lower wholesale electricity price, it will not have to close any thermal generation plant and the retail price impact will be low as most of its customers are North Island based. For these reasons we do not expect MCY to offer lower electricity prices to NZAS.

MCY's share price reaction (down -12%) relative to the downside risk it faces from NZAS closing is, therefore, out of proportion. We have lowered our target price just -2cps (risk weighting of 20% for NZAS closure) for the increased risk of NZAS closing. That said, whilst MCY now looks more attractive, we are only upgrading our rating to NEUTRAL as MCY's lift in share price over recent months was driven by MSCI inclusion more than any underlying fundamentals. Our forecast changes are minimal.

Figure 1. Summary forecast changes

	FY20		%	FY21		%	FY22		%
	Old	New		Old	New		Old	New	
Sales revenue	1,921	1,941	1.0%	1,808	1,785	-1.3%	1,770	1,732	-2.1%
<b>EBITDAF</b>	<b>514</b>	<b>516</b>	<b>0.5%</b>	<b>528</b>	<b>525</b>	<b>-0.6%</b>	<b>549</b>	<b>546</b>	<b>-0.5%</b>
EBIT	313	315	0.8%	323	320	-1.0%	349	346	-0.8%
Pre-tax profit	247	249	1.1%	254	251	-1.2%	278	275	-1.1%
<b>NPAT</b>	<b>176</b>	<b>177</b>	<b>1.1%</b>	<b>181</b>	<b>179</b>	<b>-1.2%</b>	<b>200</b>	<b>198</b>	<b>-1.1%</b>
Dividend (cps)	15.8	15.8	0.0%	16.2	16.2	0.0%	22.1	21.9	-0.9%
Generation (GWh)	6,898	6,898	0.0%	7,026	7,026	0.0%	7,314	7,314	0.0%
GWAP (\$/MWh)	\$128.5	\$131.6	2.4%	\$108.2	\$104.8	-3.2%	\$99.0	\$93.0	-6.0%
LWAP/GWAP	1.048	1.046	-0.1%	1.050	1.050	0.0%	1.054	1.054	0.0%

Source: Forsyth Barr analysis

### MCY expected to enter MSCI Index

We expect MCY will be entering the MSCI Index. The announcement will be made on Friday 8 November.

### Investment View

Our rating is NEUTRAL. MCY is a strong operator in the sector with well-positioned generation assets. Whilst its near-term dividend yield is the lowest in the sector, we expect that to improve following the completion of its Turitea windfarm in 2021. Overall we view MCY as fairly valued.

NZX Code	MCY
Share price	NZ\$4.79
Target price	NZ\$4.53
Risk rating	Low
Issued shares	1360.9m
Market cap	NZ\$6,519m
Average daily turnover	717.4k (NZ\$3,106k)

### Share Price Performance



Financials: June	19A	20E	21E	22E
NPAT* (NZ\$m)	239.0	248.4	273.8	285.0
EPS* (NZc)	17.6	18.3	20.1	20.9
EPS growth* (%)	-6.4	3.9	10.2	4.1
DPS (NZc)	15.5	15.8	16.2	21.9
Imputation (%)	100	100	100	85

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	14.7	14.2	14.1	13.6
EV/EBIT	24.6	23.3	23.2	21.9
PE	27.3	26.2	23.8	22.9
Price / NTA	1.9	1.9	1.9	n/a
Cash dividend yield (%)	3.2	3.3	3.4	4.6
Gross dividend yield (%)	4.5	4.6	4.7	6.1

\*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 06 Nov 2019: NZ\$4.79					June year end				
<b>Forsyth Barr valuation</b>						<b>Valuation Ratios</b>					
Valuation methodology						Mix of market multiple and DCF					
<b>12-month target price (NZ\$)*</b>						<b>2018A 2019A 2020E 2021E 2022E</b>					
Expected share price return	-5.4%	<b>Spot valuations (NZ\$)</b>		1. DCF	4.13	EV/EBITDA (x)	13.3	14.7	14.2	14.1	13.6
Net dividend yield	3.3%			2. Market multiple	5.00	EV/EBIT (x)	20.5	24.6	23.3	23.2	21.9
Estimated 12-month return	-2.1%			3. Dividend yield	4.49	PE (x)	25.5	27.3	26.2	23.8	22.9
<b>Key WACC assumptions</b>						<b>DCF valuation summary (NZ\$m)</b>					
Risk free rate	2.00%			Total firm value	6,930	Price/NTA (x)	2.0	1.9	1.9	1.9	1.9
Equity beta	0.88			(Net debt)/cash	(1,223)	Free cash flow yield (%)	3.8	3.1	1.7	2.9	4.6
WACC	6.6%			Value of equity	5,708	Net dividend yield (%)	3.2	3.2	3.3	3.4	4.6
Terminal growth	1.5%			Shares (m)	1,361	Gross dividend yield (%)	4.4	4.5	4.6	4.7	6.1
						<b>Imputation (%)</b>					
						<b>Pay-out ratio (%)</b>					
						<b>Capital Structure</b>					
						<b>2018A 2019A 2020E 2021E 2022E</b>					
<b>Profit and Loss Account (NZ\$m)</b>						<b>2018A 2019A 2020E 2021E 2022E</b>					
Sales revenue	1,798	2,000	1,963	1,807	1,755	Interest cover EBIT (x)	4.7	6.7	4.8	4.7	4.8
<b>Normalised EBITDA</b>	<b>566</b>	<b>505</b>	<b>516</b>	<b>525</b>	<b>546</b>	Interest cover EBITDA (x)	6.2	6.7	7.8	7.7	7.7
Depreciation and amortisation	(201)	(204)	(205)	(208)	(212)	Net debt/ND+E (%)	27.8	23.7	25.5	26.1	25.1
<b>Normalised EBIT</b>	<b>365</b>	<b>301</b>	<b>312</b>	<b>316</b>	<b>334</b>	Net debt/EBITDA (x)	2.2	2.2	2.3	2.3	2.1
Net interest	(91)	(75)	(66)	(69)	(71)	<b>Key Ratios</b>					
Associate income	2	1	3	3	3	Return on assets (%)	7.1	7.8	4.8	4.9	5.3
Tax	(91)	(73)	(72)	(72)	(77)	Return on equity (%)	6.0	4.6	5.1	5.2	5.5
Depreciation capex adj	58	78	71	95	95	Return on funds employed (%)	5.8	4.7	4.8	4.9	5.3
<b>Adjusted normalised NPAT</b>	<b>256</b>	<b>239</b>	<b>248</b>	<b>274</b>	<b>285</b>	EBITDA margin (%)	31.5	25.3	26.3	29.0	31.1
Abnormals/other	(7)	118	(71)	(95)	(95)	EBIT margin (%)	20.4	15.1	16.1	17.7	19.3
<b>Reported NPAT</b>	<b>249</b>	<b>357</b>	<b>177</b>	<b>179</b>	<b>190</b>	Capex to sales (%)	7.1	6.1	15.3	6.2	4.6
Normalised EPS (cps)	18.8	17.6	18.3	20.1	20.9	Capex to depreciation (%)	69	67	158	57	40
DPS (cps)	15.1	15.5	15.8	16.2	21.9	<b>Operating Statistics</b>					
						<b>2018A 2019A 2020E 2021E 2022E</b>					
<b>Growth Rates</b>						<b>2018A 2019A 2020E 2021E 2022E</b>					
Revenue (%)	12.6	11.2	-1.9	-7.9	-2.9	Hydro	4,947	4,006	4,088	4,016	4,016
EBITDA (%)	8.2	-10.8	2.2	1.6	4.1	Geothermal	2,757	2,894	2,810	2,829	2,829
EBIT (%)	7.9	-17.7	4.4	1.4	5.7	Wind	-	-	-	181	469
Normalised NPAT (%)	1.8	-6.5	3.9	10.2	4.1	<b>Total MCY Generation (GWh)</b>	<b>7,704</b>	<b>6,900</b>	<b>6,898</b>	<b>7,026</b>	<b>7,314</b>
Normalised EPS (%)	2.9	-6.4	3.9	10.2	4.1	GWAP (\$/MWh)	86.3	138.7	131.6	104.8	93.0
Ordinary DPS (%)	3.4	2.6	1.9	2.5	35.2	Electricity customers (000)	388	373	354	351	347
						<b>Cash Flow (NZ\$m)</b>					
						<b>2018A 2019A 2020E 2021E 2022E</b>					
<b>EBITDA</b>	<b>566</b>	<b>505</b>	<b>516</b>	<b>525</b>	<b>546</b>	MM volumes	3,278	3,182	2,972	2,908	2,885
Working capital change	4	2	52	(61)	(3)	TOU volumes	1,200	1,319	1,526	1,616	1,624
Interest & tax paid	(192)	(148)	(158)	(160)	(165)	<b>Total Fixed Price volumes (GWh)</b>	<b>4,478</b>	<b>4,501</b>	<b>4,498</b>	<b>4,524</b>	<b>4,509</b>
Other	(4)	(33)	-	-	-	Spot Sales	891	780	731	734	738
<b>Operating cash flow</b>	<b>374</b>	<b>326</b>	<b>410</b>	<b>303</b>	<b>378</b>	Net CFD's	2,110	1,624	1,563	1,563	1,563
Capital expenditure	(127)	(122)	(301)	(111)	(80)	<b>Total Sales (GWh)</b>	<b>7,479</b>	<b>6,905</b>	<b>6,791</b>	<b>6,821</b>	<b>6,810</b>
(Acquisitions)/divestments	(139)	215	-	-	-	Average usage per cust (MWh/yr)	11.4	11.8	12.5	12.8	12.9
Other	6	5	1	1	1	LWAP (\$/MWh)	91.6	144.2	137.7	110.0	98.0
<b>Funding available/(required)</b>	<b>114</b>	<b>424</b>	<b>110</b>	<b>193</b>	<b>298</b>	LWAP/GWAP	1.06	1.04	1.05	1.05	1.05
Dividends paid	(273)	(208)	(212)	(218)	(225)	Average FPVV price (\$/MWh)	112.5	113.4	114.3	116.4	118.4
Equity raised/(returned)	(55)	7	-	-	-	Line losses (%)	5.6	5.1	5.4	5.3	5.3
<b>Increase/(decrease) in net debt</b>	<b>214</b>	<b>(223)</b>	<b>102</b>	<b>25</b>	<b>(74)</b>	Retail gas customers (000)	48	47	46	46	47
						<b>Balance Sheet (NZ\$m)</b>					
						<b>2018A 2019A 2020E 2021E 2022E</b>					
Working capital	63	63	11	72	75	Retail gas volumes (PJ)	1.1	1.1	1.0	1.0	1.0
Fixed assets	5,370	5,528	5,629	5,539	5,410	Gas volume/cust (GJ/yr)	22.5	22.5	22.5	22.5	22.5
Intangibles	85	62	59	57	55	Energy margin (\$m)	730	667	700	706	735
Other assets	385	521	523	526	529	Operating costs (\$m)	(205)	(199)	(203)	(202)	(208)
<b>Total funds employed</b>	<b>5,903</b>	<b>6,174</b>	<b>6,223</b>	<b>6,194</b>	<b>6,069</b>	Other revenue (\$m)	41	37	19	20	20
Net debt/(cash)	1,264	1,096	1,198	1,223	1,149	<b>MCY EBITDAF (\$m)</b>	<b>566</b>	<b>505</b>	<b>516</b>	<b>525</b>	<b>546</b>
Other non current liabilities	1,306	1,498	1,480	1,464	1,448						
Shareholder's funds	3,333	3,580	3,545	3,506	3,472						
Minority interests	-	-	-	-	-						
<b>Total funding sources</b>	<b>5,903</b>	<b>6,174</b>	<b>6,223</b>	<b>6,194</b>	<b>6,069</b>						

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

## Investment summary

Our rating is **NEUTRAL**. MCY is a strong operator in the sector with well-positioned generation assets. Whilst its near-term dividend yield is the lowest in the sector, we expect that to improve following the completion of its Turitea windfarm in 2021. 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.

### 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 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.

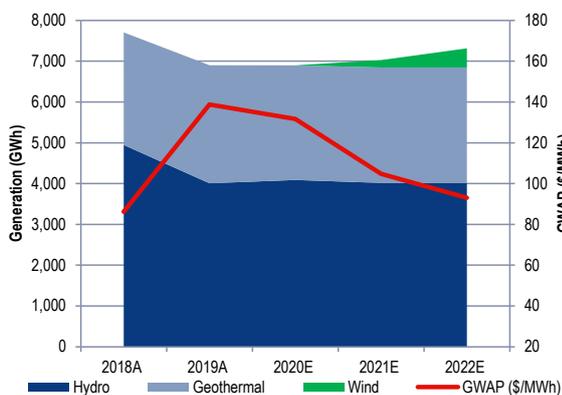
### Financial structure

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

### Key risks

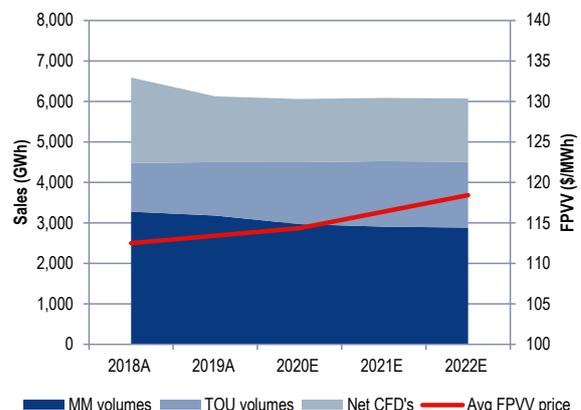
- **Political/regulatory:** The 2014 election and recent Electricity Price Review (EPR) highlighted the political/regulatory risks inherent in the sector. Whilst the EPR gave the sector a thumbs up in most areas, the political risk is unlikely to ever disappear.
- **NZAS risk:** NZAS has indicated it is undertaking a strategic review, raising the possibility it may close. In our view, the smelter is unlikely to close (less than 10% chance) and the downside risks are fully factored into the share price.
- **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 2. Generation volumes and average price received



Source: MCY, Forsyth Barr analysis

Figure 3. Sales volumes and average price received



Source: MCY, Forsyth Barr analysis

**Figure 4. Substantial Shareholders**

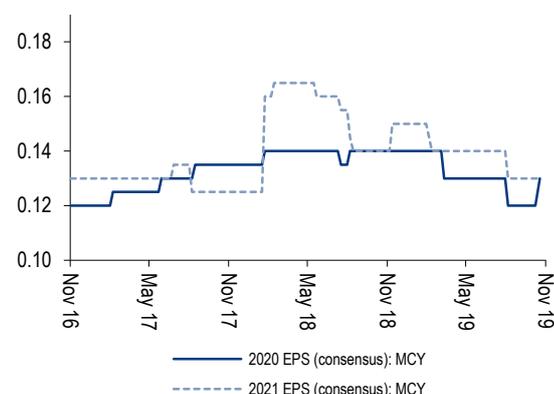
Shareholder	Latest Holding
NZ Govt	52.6%

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

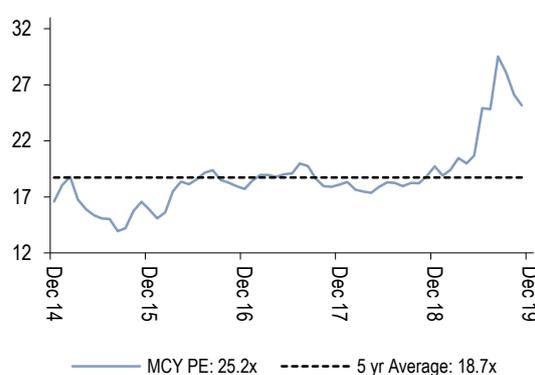
**Figure 5. International Compcos**

Company <i>(metrics re-weighted to reflect MCY's balance date - June)</i>	Code	Price	Mkt Cap (m)	PE		EV/EBITDA		EV/EBIT		Cash D/Yld	
				2020E	2021E	2020E	2021E	2020E	2021E		
Mercury	MCY NZ	NZ\$4.79	NZ\$6,519	26.2x	23.8x	14.7x	14.5x	24.2x	23.8x	3.4%	
Contact Energy *	CEN NZ	NZ\$7.25	NZ\$5,204	20.9x	20.0x	13.2x	12.7x	23.3x	21.8x	5.4%	
Genesis Energy *	GNE NZ	NZ\$3.18	NZ\$3,274	20.9x	16.5x	12.2x	10.9x	28.9x	22.7x	5.6%	
Meridian Energy *	MEL NZ	NZ\$4.60	NZ\$11,790	24.6x	26.8x	16.1x	17.2x	25.9x	28.3x	4.7%	
Trustpower *	TPW NZ	NZ\$8.26	NZ\$2,585	24.4x	23.5x	14.9x	14.4x	18.7x	18.0x	4.3%	
AGL Energy	AGL AT	A\$19.66	A\$12,760	15.1x	15.1x	7.4x	7.3x	11.2x	11.4x	5.0%	
ERM Power	EPW AT	A\$2.41	A\$603	12.1x	16.2x	7.1x	6.7x	10.1x	9.5x	4.2%	
Origin Energy	ORG AT	A\$8.07	A\$14,213	13.7x	13.2x	6.3x	6.2x	13.8x	13.4x	4.5%	
<b>Compcro Average:</b>				<b>18.8x</b>	<b>18.8x</b>	<b>11.0x</b>	<b>10.8x</b>	<b>18.9x</b>	<b>17.9x</b>	<b>4.8%</b>	
<i>EV = Current Market Cap + Actual Net Debt</i>				<b>MCY Relative:</b>	<b>+39%</b>	<b>+27%</b>	<b>+34%</b>	<b>+35%</b>	<b>+28%</b>	<b>+33%</b>	<b>-30%</b>

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

**Figure 6. Consensus EPS Momentum**


Source: Forsyth Barr analysis, Bloomberg

**Figure 7. 12 Month Forward PE**


Source: Forsyth Barr analysis

**Not personalised financial advice:** The recommendations and opinions in this publication do not take into account your personal financial situation or investment goals. The financial products referred to in this publication may not be suitable for you. If you wish to receive personalised financial advice, please contact your Forsyth Barr Investment Adviser. The value of financial products may go up and down and investors may not get back the full (or any) amount invested. Past performance is not necessarily indicative of future performance. Disclosure statements for Forsyth Barr Investment Advisers are available on request and free of charge. **Disclosure:** Forsyth Barr Limited and its related companies (and their respective directors, officers, agents and employees) ("Forsyth Barr") may have long or short positions or otherwise have interests in the financial products referred to in this publication, and may be directors or officers of, and/or provide (or be intending to provide) investment banking or other services to, the issuer of those financial products (and may receive fees for so acting). Forsyth Barr is not a registered bank within the meaning of the Reserve Bank of New Zealand Act 1989. Forsyth Barr may buy or sell financial products as principal or agent, and in doing so may undertake transactions that are not consistent with any recommendations contained in this publication. Forsyth Barr confirms no inducement has been accepted from the researched entity, whether pecuniary or otherwise, in connection with making any recommendation contained in this publication. **Analyst Disclosure Statement:** In preparing this publication the analyst(s) may or may not have a threshold interest in the financial products referred to in this publication. For these purposes a threshold interest is defined as being a holder of more than \$50,000 in value or 1% of the financial products on issue, whichever is the lesser. In preparing this publication, non-financial assistance (for example, access to staff or information) may have been provided by the entity being researched. **Disclaimer:** This publication has been prepared in good faith based on information obtained from sources believed to be reliable and accurate. However, that information has not been independently verified or investigated by Forsyth Barr. Forsyth Barr does not make any representation or warranty (express or implied) that the information in this publication is accurate or complete, and, to the maximum extent permitted by law, excludes and disclaims any liability (including in negligence) for any loss which may be incurred by any person acting or relying upon any information, analysis, opinion or recommendation in this publication. Forsyth Barr does not undertake to keep current this publication; any opinions or recommendations may change without notice. Any analyses or valuations will typically be based on numerous assumptions; different assumptions may yield materially different results. Nothing in this publication should be construed as a solicitation to buy or sell any financial product, or to engage in or refrain from doing so, or to engage in any other transaction. Other Forsyth Barr business units may hold views different from those in this publication; any such views will generally not be brought to your attention. This publication is not intended to be distributed or made available to any person in any jurisdiction where doing so would constitute a breach of any applicable laws or regulations or would subject Forsyth Barr to any registration or licensing requirement within such jurisdiction. **Terms of use:** Copyright Forsyth Barr Limited. You may not redistribute, copy, revise, amend, create a derivative work from, extract data from, or otherwise commercially exploit this publication in any way. By accessing this publication via an electronic platform, you agree that the platform provider may provide Forsyth Barr with information on your readership of the publications available through that platform.