Mercury

NEUTRAL

Winding Up Turitea Stage 2

Mercury's (MCY) biennial investor day was overshadowed by the news that MCY has committed to building stage two of its Turitea wind farm. Whilst the decision is interesting in light of NZAS's strategic review creating market uncertainty, our analysis indicates the project should be value positive with a wholesale electricity price above $60/MWh, hence, there is good downside protection if NZAS were to close.

What's changed?

- **Earnings:** FY20E unchanged, FY21E/FY22E EBITDAF up +$2m/+$11m
- **Target Price:** Increased +9cps to $4.62 mainly due to Turitea South
- **Rating:** NEUTRAL rating retained

Turitea South value positive

MCY has pushed go on Stage 2 of its Turitea wind farm, adding a further 103MW/370GWh pa to the Turitea North wind farm. The announcement was a slight surprise given the NZAS strategic review has created electricity demand (and therefore electricity price) uncertainty. However, the economics stack up, even if NZAS were to close. Add in the fact that the resource consents were due to expire in 2021 and the announcement will make other generators think twice about building their own projects, and the decision is understandable. We estimate that the Turitea South ungeared IRR is above 10% and will add ~+5cps. MCY has indicated at an ~$80MWh price Turitea South will add EBITDAF of ~$25m (albeit not until FY23), in addition to the ~$30m from Turitea North.

Dividend path flattened in FY22, increased in FY23 and beyond

We have lowered our FY22 dividend forecast -3.3cps to 18.6cps as we now assume a lower payout ratio until the wind farm is commissioned and there is a full year of earnings in FY23. This is still +2.4cps up on our FY21 forecast and reflects earnings from Turitea Stage 1. However, the FY23 dividend assumption is now +1.5cps higher at 23.1cps (a cash yield of 4.6%).

C&I book roll-off guidance confirms solid earnings growth

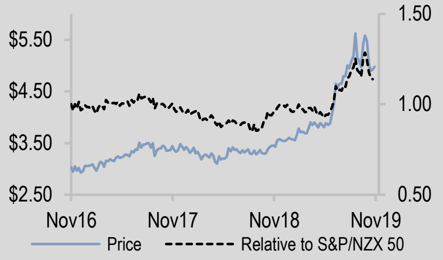
MCY has solid earnings growth in the next two financial years, before Turitea wind farm earnings kick in from FY22 onwards. At the end of FY19 MCY's commercial and industrial sales yet to be contracted at the current wholesale electricity prices totalled ~2,000GWh. With the long-dated futures prices ~+$20/MWh higher than 12-months ago, MCY's commercial sales will add ~+$40m to EBITDAF over the next four/five years it will take to re-contract (assuming wholesale prices hold). We currently assume wholesale electricity prices decline from current elevated levels, so the upside is not quite +$40m. MCY also indicated it is seeking ~+$20m EBITDAF growth from general operational improvements by FY22. Whilst we have lifted our FY22 EBITDAF forecast +$11m to $557m (~70% of which is due to Turitea South commissioning volumes), we have not explicitly included these operational improvements.

Investment View

Our rating is NEUTRAL. MCY is a quality operator in a sector with a positive long-term outlook. Whilst MCY demonstrated at its investor day that it has a solid near-term earnings growth profile, we believe that is largely factored into the current share price.

NZX Code	MCY
Share price	NZ$4.98
Target price	NZ$4.62
Risk rating	Low
Issued shares	1360.9m
Market cap	NZ$6,777m
Average daily turnover	747.7k (NZ$3,267k)

Share Price Performance



Financials: June	19A	20E	21E	22E
NPAT* (NZ$m)	239.0	248.9	276.7	292.0
EPS* (NZc)	17.6	18.3	20.3	21.5
EPS growth* (%)	-6.4	4.1	11.2	5.5
DPS (NZc)	15.5	15.8	16.2	18.8
Imputation (%)	100	100	100	95

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	15.2	14.7	14.5	13.7
EV/EBIT	25.5	24.2	23.7	21.8
PE	28.4	27.2	24.5	23.2
Price / NTA	2.0	2.0	2.0	n/a
Cash dividend yield (%)	3.1	3.2	3.3	3.8
Gross dividend yield (%)	4.3	4.4	4.5	5.2

*Historic and forecast numbers based on underlying profits

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Mercury NZ Limited (MCY)		Priced as at 12 Nov 2019: NZ$4.98	
Forsyth Barr valuation			
Valuation methodology			Mix of market multiple and DCF
12-month target price (NZ$)*	**4.62**	**Spot valuations (NZ$)**	
Expected share price return	-7.2%	1. DCF	4.33
Net dividend yield	3.2%	2. Market multiple	5.03
Estimated 12-month return	-4.0%	3. Dividend yield	4.49
Key WACC assumptions		**DCF valuation summary (NZ$m)**	
Risk free rate	2.00%	Total firm value	7,205
Equity beta	0.88	(Net debt)/cash	(1,223)
WACC	6.6%	Value of equity	5,982
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	1,963	1,809	1,768
Normalised EBITDA	**566**	**505**	**516**	**527**	**557**
Depreciation and amortisation	(201)	(204)	(205)	(207)	(209)
Normalised EBIT	**365**	**301**	**311**	**320**	**348**
Net interest	(91)	(75)	(66)	(69)	(74)
Associate income	2	1	3	3	3
Tax	(91)	(73)	(72)	(73)	(80)
Depreciation capex adj	58	78	72	95	94
Adjusted normalised NPAT	**256**	**239**	**249**	**277**	**292**
Abnormals/other	(7)	118	(72)	(95)	(94)
Reported NPAT	**249**	**357**	**177**	**182**	**198**
Normalised EPS (cps)	18.8	17.6	18.3	20.3	21.5
DPS (cps)	15.1	15.5	15.8	16.2	18.8

Growth Rates	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Revenue (%)	12.6	11.2	-1.9	-7.9	-2.2
EBITDA (%)	8.2	-10.8	2.2	2.1	5.6
EBIT (%)	7.9	-17.7	4.2	2.9	8.5
Normalised NPAT (%)	1.8	-6.5	4.1	11.2	5.5
Normalised EPS (%)	2.9	-6.4	4.1	11.2	5.5
Ordinary DPS (%)	3.4	2.6	1.9	2.5	16.0

Cash Flow (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EBITDA	**566**	**505**	**516**	**527**	**557**
Working capital change	4	2	52	(40)	(21)
Interest & tax paid	(192)	(148)	(158)	(162)	(173)
Other	(4)	(33)	-	-	-
Operating cash flow	**374**	**326**	**410**	**326**	**363**
Capital expenditure	(127)	(122)	(300)	(245)	(151)
(Acquisitions)/divestments	(139)	215	-	-	-
Other	6	5	1	1	1
Funding available/(required)	**114**	**424**	**111**	**81**	**212**
Dividends paid	(273)	(208)	(212)	(218)	(225)
Equity raised/(returned)	(55)	7	-	-	-
Increase/(decrease) in net debt	**214**	**(223)**	**102**	**137**	**12**

Balance Sheet (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Working capital	63	63	11	51	71
Fixed assets	5,370	5,528	5,632	5,680	5,632
Intangibles	85	62	55	50	46
Other assets	385	521	523	526	529
Total funds employed	**5,903**	**6,174**	**6,222**	**6,307**	**6,278**
Net debt/(cash)	1,264	1,096	1,198	1,334	1,347
Other non current liabilities	1,306	1,498	1,479	1,464	1,450
Shareholder's funds	3,333	3,580	3,545	3,509	3,482
Minority interests	-	-	-	-	-
Total funding sources	**5,903**	**6,174**	**6,222**	**6,307**	**6,278**

June year end

Valuation Ratios	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EV/EBITDA (x)	13.7	15.2	14.7	14.5	13.7
EV/EBIT (x)	21.2	25.5	24.2	23.7	21.8
PE (x)	26.5	28.4	27.2	24.5	23.2
Price/NTA (x)	2.1	2.0	2.0	2.0	2.0
Free cash flow yield (%)	3.6	3.0	1.6	1.2	3.1
Net dividend yield (%)	3.0	3.1	3.2	3.3	3.8
Gross dividend yield (%)	4.2	4.3	4.4	4.5	5.2
Imputation (%)	100	100	100	100	95
Pay-out ratio (%)	80	88	86	80	88

Capital Structure	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Interest cover EBIT (x)	4.7	6.7	4.8	4.7	4.8
Interest cover EBITDA (x)	6.2	6.7	7.8	7.7	7.6
Net debt/ND+E (%)	27.8	23.7	25.5	27.8	28.1
Net debt/EBITDA (x)	2.2	2.2	2.3	2.5	2.4

Key Ratios	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Return on assets (%)	7.1	7.8	4.8	4.9	5.4
Return on equity (%)	6.0	4.6	5.1	5.2	5.8
Return on funds employed (%)	5.8	4.7	4.8	4.8	5.2
EBITDA margin (%)	31.5	25.3	26.3	29.2	31.5
EBIT margin (%)	20.4	15.1	16.0	17.9	19.9
Capex to sales (%)	7.1	6.1	15.3	13.6	8.6
Capex to depreciation (%)	69	67	161	129	78

Operating Statistics	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Hydro	4,947	4,006	4,088	4,016	4,016
Geothermal	2,757	2,894	2,810	2,829	2,829
Wind	-	-	-	181	562
Total MCY Generation (GWh)	**7,704**	**6,900**	**6,898**	**7,026**	**7,407**
GWAP ($/MWh)	86.3	138.7	131.6	104.4	92.8
Electricity customers (000)	388	373	354	351	347
MM volumes	3,278	3,182	2,972	2,908	2,885
TOU volumes	1,200	1,319	1,526	1,616	1,624
Total Fixed Price volumes (GWh)	**4,478**	**4,501**	**4,498**	**4,524**	**4,509**
Spot Sales	891	780	731	734	738
Net CFD's	2,110	1,624	1,563	1,563	1,563
Total Sales (GWh)	**7,479**	**6,905**	**6,791**	**6,821**	**6,810**
Average usage per cust (MWh/yr)	11.4	11.8	12.5	12.8	12.9
LWAP ($/MWh)	91.6	144.2	137.7	109.7	98.0
LWAP/GWAP	1.06	1.04	1.05	1.05	1.06
Average FPVV price ($/MWh)	112.5	113.4	114.3	117.2	119.8
Line losses (%)	5.6	5.1	5.4	5.3	5.3
Retail gas customers (000)	48	47	46	46	47
Retail gas volumes (PJ)	1.1	1.1	1.0	1.0	1.0
Gas volume/cust (GJ/yr)	22.5	22.5	22.5	22.5	22.5
Energy margin ($m)	730	667	700	709	747
Operating costs ($m)	(205)	(199)	(203)	(202)	(210)
Other revenue ($m)	41	37	19	20	20
MCY EBITDAF ($m)	**566**	**505**	**516**	**527**	**557**

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

Turitea wind farm summary analysis

Figure 1. Turitea key facts

	South (Stage 2)	North (Stage 1)	Total
Capacity (MW)	102.6	118.8	**221.4**
Annual production (GWh)	~370	~470	**840**
Capacity Factor	41.1%	45.1%	**43.3%**
Capex ($m)	208	256	**464**
Capex/MW ($m)	2.0	2.2	**2.1**
Commissioning date	Late 2021	Late 2020	

Source: MCY, Forsyth Barr analysis

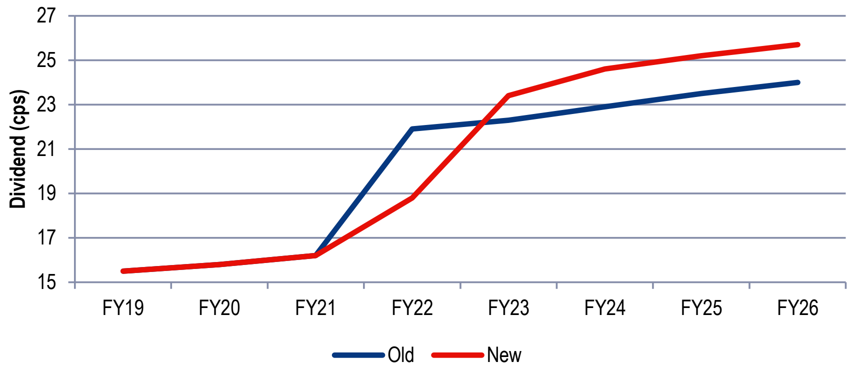
Figure 2. Summary Turitea South wind farm valuation uplift/sensitivity

$/MWh	$60	$65	$70	$75	$80	$85	$90
NPV (cps)	0.3	1.5	2.8	4.0	5.3	6.5	7.8
IRR	6.9%	7.8%	8.6%	9.4%	10.2%	11.0%	11.8%
EBITDAF ($m)	$19	$21	$22	$24	$26	$28	$30

Source: Forsyth Barr analysis

Dividend forecast changes

Figure 3. Dividend forecast changes



Source: Forsyth Barr analysis

Note: We assume 100% free cash flow payout ratio following the completion of the Turitea wind farm as MCY has a track record of paying surplus capital back to shareholders.

Summary forecast changes

Figure 4. Summary forecast changes

	FY20 Old	FY20 New	% Chg	FY21 Old	FY21 New	% Chg	FY22 Old	FY22 New	% Chg
Sales revenue	1,941	1,941	0.0%	1,785	1,786	0.1%	1,732	1,745	0.7%
EBITDAF	**516**	**516**	**0.0%**	**525**	**527**	**0.5%**	**546**	**557**	**2.0%**
EBIT	315	315	-0.1%	320	324	1.3%	346	359	3.9%
Pre-tax profit	249	249	-0.2%	251	255	1.6%	275	286	3.9%
NPAT	**177**	**177**	**-0.2%**	**179**	**182**	**1.6%**	**198**	**206**	**3.9%**
Normalised NPAT	**177**	**177**	**-0.2%**	**179**	**182**	**1.6%**	**190**	**198**	**4.1%**
Dividend (cps)	15.8	15.8	0.0%	16.2	16.2	0.0%	21.9	18.8	-14.2%
Generation (GWh)	6,898	6,898	0.0%	7,026	7,026	0.0%	7,314	7,407	1.3%
FPVV sales (GWh)	4,498	4,498	0.0%	4,524	4,524	0.0%	4,509	4,509	0.0%
Customer numbers (000)	354	354	0.0%	351	351	0.0%	347	347	0.0%
GWAP ($/MWh)	$131.6	$131.6	0.0%	$104.8	$104.4	-0.3%	$93.0	$92.8	-0.3%
LWAP/GWAP	1.046	1.046	0.0%	1.050	1.051	0.1%	1.054	1.056	0.3%

Source: Forsyth Barr analysis

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 FY21:** MCY's move into a development phase will drive earnings growth after FY21. The new wind farm development at Turitea is likely to add ~$55m (~+11%) 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.

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.

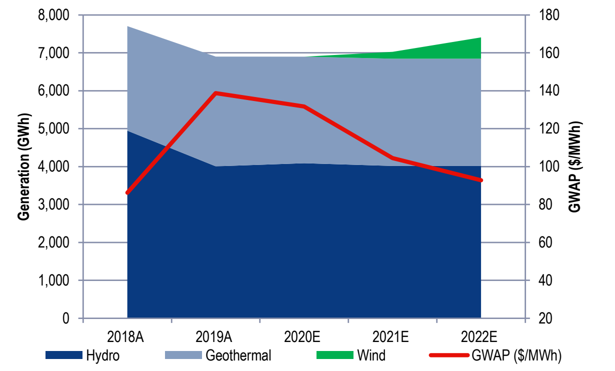
Key risks

- **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.

Company description

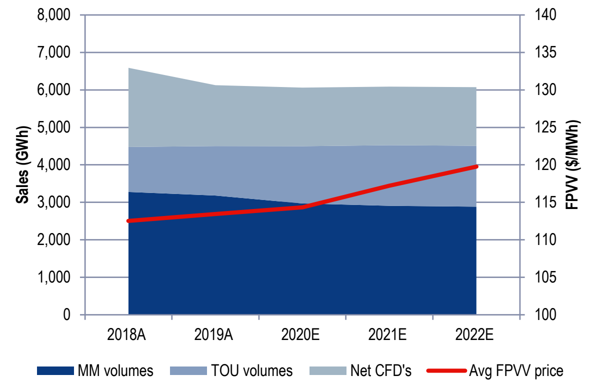
MCY is one of New Zealand's large electricity generator/retailers. It is a 100% renewable generator producing ~6,800GWh of electricity from its North Island based Waikato River hydro power station and geothermal power stations. MCY is developing its first wind farm which is expected to produce ~470GWh 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 5. Generation volumes and average price received



Source: Forsyth Barr analysis

Figure 6. Sales volumes and average price received



Source: Forsyth Barr analysis

Figure 7. Substantial Shareholders

Shareholder	Latest Holding
NZ Govt	52.6%

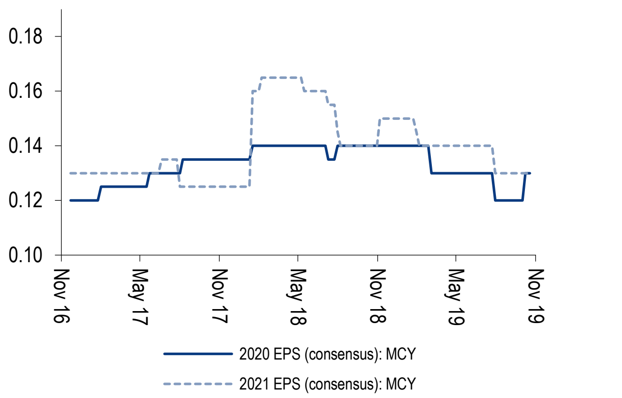
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 8. 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$4.98**	**NZ$6,777**	**27.2x**	**24.5x**	**15.2x**	**14.9x**	**25.0x**	**24.3x**	**3.3%**
Contact Energy *	CEN NZ	NZ$7.24	NZ$5,197	20.9x	20.0x	13.2x	12.7x	23.3x	21.7x	5.5%
Genesis Energy *	GNE NZ	NZ$3.30	NZ$3,397	21.7x	17.1x	12.6x	11.2x	29.7x	23.4x	5.3%
Meridian Energy *	MEL NZ	NZ$4.64	NZ$11,892	24.9x	27.9x	16.3x	17.7x	26.3x	29.6x	4.7%
Trustpower *	TPW NZ	NZ$7.55	NZ$2,363	24.3x	22.7x	14.3x	13.8x	17.7x	17.0x	4.5%
AGL Energy	AGL AT	A$20.14	A$13,072	15.5x	15.5x	7.5x	7.5x	11.5x	11.6x	4.9%
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$8.25	A$14,530	14.1x	13.5x	6.4x	6.2x	15.5x	15.1x	4.4%
			Compco Average:	**19.1x**	**19.0x**	**11.0x**	**10.8x**	**19.1x**	**18.3x**	**4.8%**
EV = Current Market Cap + Actual Net Debt			**MCY Relative:**	**+43%**	**+29%**	**+38%**	**+38%**	**+31%**	**+33%**	**-32%**

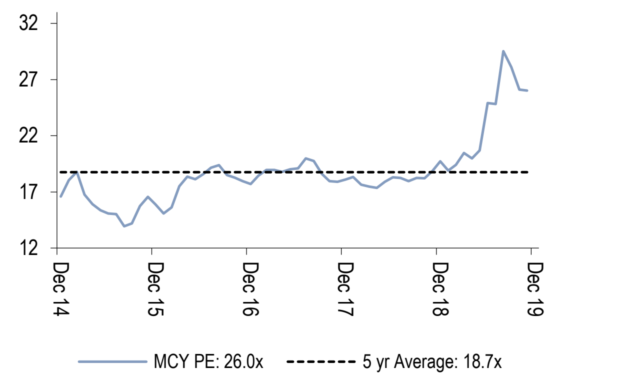
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (MCY) companies fiscal year end

Figure 9. Consensus EPS Momentum



Source: Forsyth Barr analysis, Bloomberg

Figure 10. 12 Month Forward PE



Source: Forsyth Barr analysis

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