FORSYTH BARR

Mercury

NEUTRAL

Better Prices, Weaker Volumes — 2Q20 Operating Statistics

Mercury's (MCY) 2Q20 was characterised by weaker generation and sales volumes, but the sales volumes were at better prices. Whilst we have downgraded FY20 EBITDAF slightly on the weaker than expected sales volumes (down -$5m to $511m), we believe MCY is well positioned for 2H20.

What's changed?

- **Earnings:** FY20 EBITDAF lowered -$5m to $511m
- **Target Price:** Down -2cps to $4.60
- **Rating:** NEUTRAL rating retained

Better prices offset weaker volumes

Retail prices were strong, with mass market prices lifting +2.3% and commercial prices increasing +7.6%. We suspect the increase in mass market prices was partly mix related as low-priced Farm Source connections were not in 2Q20 figures. Commercial pricing showed a strong uplift as more high-priced contracts (due to the strength of wholesale electricity prices) are added to MCY's portfolio.

However, generation volumes were off -8.5% and retail sales volumes were off -6.1% vs. pcp. Mass market sales were down -11.4% due to lower connection numbers (down -6.6% vs. pcp) and the loss of the high volume (low margin) Farm Source connections. Geothermal generation volumes were weak due to scheduled maintenance.

Setting up for strong 2H20

Contributing to the low generation volumes, MCY deliberately held back water in 2Q20 so that it could start 2H20 with above average hydro storage volumes. Wholesale electricity prices are expected to firm during 3Q20 due to gas field and HVDC outages which should enable MCY to make more from its generation in 3Q20 than it otherwise did in 2Q20.

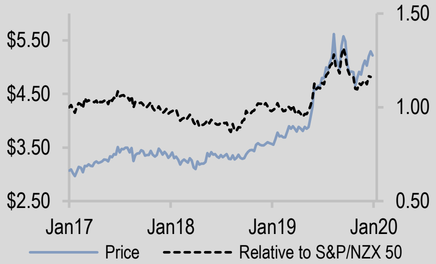
Minor forecast changes

Both the sales volumes and generation volumes were a little below expectations, hence, we have pulled back our FY20 EBITDAF forecast -$5m to $511m — close to MCY's $510m guidance. Later forecasts are little changed.

Our 1H20 EBITDAF forecast is $254m, -$48m lower than the pcp (which was remarkably strong). MCY will be reporting its 1H20 result on Tuesday, 25 February.

NZX Code	MCY
Share price	NZ$5.22
Target price	NZ$4.60
Risk rating	Low
Issued shares	1360.9m
Market cap	NZ$7,104m
Avg daily turnover	1,052k (NZ$4,857k)

Share Price Performance



Financials	19A	20E	21E	22E
NPAT* (NZ$m)	239.0	243.1	271.5	286.7
EPS* (NZc)	17.6	17.9	20.0	21.1
EPS growth* (%)	-6.4	1.7	11.7	5.6
DPS (NZc)	15.5	15.8	16.2	18.7
Imputation (%)	100	100	100	95

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	15.9	15.5	15.3	14.5
EV/EBIT	26.5	25.3	24.8	22.9
PE	29.7	29.2	26.2	24.8
Price / NTA	2.0	2.1	2.1	n/a
Cash div yld (%)	3.0	3.0	3.1	3.6
Gross div yld (%)	4.1	4.2	4.3	4.9

*Historic/forecast numbers based on normalised profits

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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 see MCY as fairly valued.

Mercury NZ Limited (MCY)

Priced as at 23 Jan 2020 (NZ$)	**5.22**

12-month target price (NZ$)*	4.60
Expected share price return	-11.9%
Net dividend yield	3.1%
Estimated 12-month return	-8.8%

Key WACC assumptions	
Risk free rate	2.00%
Equity beta	0.88
WACC	6.8%
Terminal growth	1.5%

Profit and Loss Account (NZ$m)	2018A	2019A	2020E	2021E	2022E
Sales revenue	1,798	2,000	1,865	1,787	1,732
Normalised EBITDA	**566**	**505**	**511**	**523**	**552**
Depreciation and amortisation	(201)	(204)	(197)	(200)	(203)
Normalised EBIT	**365**	**301**	**314**	**322**	**349**
Net interest	(91)	(75)	(66)	(69)	(74)
Associate income	2	1	-	-	-
Tax	(91)	(73)	(71)	(73)	(79)
Depreciation capex adj	58	78	67	91	91
Adjusted normalised NPAT	**256**	**239**	**243**	**272**	**287**
Abnormals/other	(7)	118	(67)	(91)	(91)
Reported NPAT	**249**	**357**	**176**	**180**	**196**
Normalised EPS (cps)	18.8	17.6	17.9	20.0	21.1
DPS (cps)	15.1	15.5	15.8	16.2	18.7

Growth Rates	2018A	2019A	2020A	2021A	2022A
Revenue (%)	12.6	11.2	-6.8	-4.2	-3.0
EBITDA (%)	8.2	-10.8	1.2	2.3	5.7
EBIT (%)	7.9	-17.7	3.9	2.7	8.3
Normalised NPAT (%)	1.8	-6.5	1.7	11.7	5.6
Normalised EPS (%)	2.9	-6.4	1.7	11.7	5.6
Ordinary DPS (%)	3.4	2.6	1.9	2.5	15.4

Cash Flow (NZ$m)	2018A	2019A	2020E	2021E	2022E
EBITDA	**566**	**505**	**511**	**523**	**552**
Working capital change	4	2	45	(33)	(20)
Interest & tax paid	(192)	(148)	(156)	(160)	(172)
Other	(4)	(33)	-	-	-
Operating cash flow	**374**	**326**	**400**	**330**	**361**
Capital expenditure	(127)	(122)	(299)	(244)	(150)
(Acquisitions)/divestments	(139)	215	-	-	-
Other	1	12	(2)	(3)	(3)
Funding available/(required)	**109**	**431**	**98**	**83**	**208**
Dividends paid	(273)	(208)	(212)	(218)	(225)
Equity raised/(returned)	(50)	-	-	-	-
(Increase)/decrease in net debt	**(214)**	**223**	**(114)**	**(134)**	**(17)**

Balance Sheet (NZ$m)	2018A	2019A	2020E	2021E	2022E
Working capital	63	63	18	51	71
Fixed assets	5,370	5,528	5,635	5,686	5,640
Intangibles	85	62	59	57	55
Right of use asset	-	-	-	-	-
Other assets	385	521	523	526	529
Total funds employed	**5,903**	**6,174**	**6,236**	**6,319**	**6,294**
Net debt/(cash)	1,264	1,096	1,210	1,345	1,362
Lease liability	-	-	-	-	-
Other liabilities	1,306	1,498	1,482	1,468	1,455
Shareholder's funds	3,333	3,580	3,544	3,506	3,478
Minority interests	-	-	-	-	-
Total funding sources	**5,903**	**6,174**	**6,236**	**6,319**	**6,294**

Spot valuations (NZ$)	
1. DCF	4.22
2. Market multiple	5.00
3. Dividend yield	4.53

DCF valuation summary (NZ$m)	
Total firm value	7,063
(Net debt)/cash	(1,223)
Less: Capitalised operating leases	
Value of equity	5,841

Valuation Ratios	2018A	2019A	2020E	2021E	2022E
EV/EBITDA (x)	14.3	15.9	15.5	15.3	14.5
EV/EBIT (x)	22.1	26.5	25.3	24.8	22.9
PE (x)	27.8	29.7	29.2	26.2	24.8
Price/NTA (x)	2.2	2.0	2.1	2.1	2.1
Free cash flow yield (%)	3.5	2.9	1.4	1.2	3.0
Net dividend yield (%)	2.9	3.0	3.0	3.1	3.6
Gross dividend yield (%)	4.0	4.1	4.2	4.3	4.9

Capital Structure	2018A	2019A	2020E	2021E	2022E
Interest cover EBIT (x)	4.7	6.7	4.7	4.7	4.7
Interest cover EBITDA (x)	6.2	6.7	7.7	7.6	7.5
Net debt/ND+E (%)	70.8	61.8	65.3	69.0	70.3
Net debt/EBITDA (x)	2.2	2.2	2.4	2.6	2.5

Key Ratios	2018A	2019A	2020E	2021E	2022E
Return on assets (%)	7.1	7.8	4.8	4.9	5.3
Return on equity (%)	6.0	4.6	5.0	5.2	5.7
Return on funds employed (%)	5.8	4.7	4.8	4.8	5.2
EBITDA margin (%)	31.5	25.3	27.4	29.3	31.9
EBIT margin (%)	20.4	15.1	16.8	18.0	20.1
Capex to sales (%)	7.1	6.1	16.1	13.6	8.7
Capex to depreciation (%)	69	67	164	131	79
Imputation (%)	100	100	100	100	95
Pay-out ratio (%)	80	88	88	81	89

Operating Performance	2018A	2019A	2020E	2021E	2022E
Hydro	4,947	4,006	4,050	4,016	4,016
Geothermal	2,757	2,894	2,795	2,843	2,843
Wind	-	-	-	181	562
Total MCY Generation (GWh)	**7,704**	**6,900**	**6,845**	**7,040**	**7,421**
GWAP ($/MWh)	86	139	121	107	93
Electricity sales					
Electricity customers (000)	388	373	352	349	345
MM volumes	3,278	3,182	2,910	2,843	2,821
TOU volumes	1,200	1,319	1,460	1,519	1,527
Total Fixed Price volumes (GWh)	**4,478**	**4,501**	**4,370**	**4,363**	**4,347**
Spot Sales	891	780	729	732	736
Net CFD's	2,110	1,665	1,775	1,775	1,775
Total Sales (GWh)	**7,479**	**6,946**	**6,874**	**6,870**	**6,858**
Average usage per cust (MWh/yr)	11.4	11.8	12.2	12.4	12.5
LWAP ($/MWh)	92	145	126	113	98
LWAP/GWAP	1.06	1.04	1.04	1.05	1.06
Average FPVV price ($/MWh)	113	113	115	117	119
Line losses (%)	5.6	5.1	5.1	5.3	5.3
Energy margin ($m)	730	667	695	705	742
Operating costs ($m)	(205)	(199)	(203)	(202)	(210)
Other revenue ($m)	41	37	19	20	20
MCY EBITDAF ($m)	**566**	**505**	**511**	**523**	**552**

2Q20 operating statistics

Figure 1. 2Q20 operating statistics commentary

	Dec-18 2Q19	Dec-19 2Q20	% Chg	Comments
Fixed price, variable volume (FPVV) retail sales (GWh)				
Mass market (MM)	748	663	-11.4%	Decline due to lower, high volume connection numbers
Commercial & industrial (C&I)	319	339	6.3%	MCY continues to be active in the commercial market
Total FPVV sales	**1,067**	**1,002**	**-6.1%**	
End user CFDs	295	313	6.1%	
Total FPVV & end user CFDs	**1,362**	**1,315**	**-3.5%**	
Customer numbers	381,000	356,000	-6.6%	Big step down in connections vs. pcp following loss of dairy related contracts
Customer adds during quarter	(5,000)	(5,000)		Customer declines have continued in 2Q20
MM vol/cust (MWh/customer)	1.95	1.85	-5.2%	Big drop in volume due to dairy farm volumes dropping off
MM price ($/MWh)	126.5	129.4	2.3%	Modest price increase
C&I price ($/MWh)	74.3	79.9	7.6%	Strong price increase as firm ASX prices continue to feed into higher C&I prices
FPVV sales price	**110.9**	**112.6**	**1.6%**	
LWAP ($/MWh)	213.0	109.5	-48.6%	
Generation (GWh)				
Hydro	1,002	928	-7.4%	Hydro generation down as MCY stored water ahead of 2H20
Geothermal	721	648	-10.1%	Weak generation volumes due to scheduled maintenance
Total	**1,723**	**1,576**	**-8.5%**	
Hydro diff to average	(23)	(97)		Deliberate water storage strategy contributed to below average hydro generation
GWAP ($/MWh)	205.3	103.5	-49.6%	Strong wholesale prices, but only half the record 2Q19 period
LWAP/GWAP	1.043	1.058	1.4%	Deterioration in headline LWAP/GWAP

Source: MCY, Forsyth Barr analysis

Forecast changes

Figure 2. Summary forecast changes

	FY20 Old	FY20 New	% Chg	FY21 Old	FY21 New	% Chg	FY22 Old	FY22 New	% Chg
Sales revenue	1,941	1,842	-5.1%	1,782	1,764	-1.0%	1,739	1,709	-1.7%
EBITDAF	**516**	**511**	**-1.0%**	**524**	**523**	**-0.2%**	**551**	**552**	**0.2%**
EBIT	322	314	-2.7%	327	322	-1.3%	359	353	-1.8%
Pre-tax profit	256	247	-3.5%	258	253	-1.9%	285	279	-2.4%
NPAT	**183**	**176**	**-3.5%**	**184**	**180**	**-1.9%**	**206**	**200**	**-2.9%**
Normalised NPAT	**183**	**176**	**-3.5%**	**184**	**180**	**-1.9%**	**198**	**196**	**-1.0%**
Dividend (cps)	15.8	15.8	0.0%	16.2	16.2	0.0%	18.6	18.7	0.5%
Generation (GWh)	6,898	6,845	-0.8%	7,026	7,040	0.2%	7,407	7,421	0.2%
FPVV sales (GWh)	4,498	4,370	-2.8%	4,524	4,363	-3.6%	4,509	4,347	-3.6%
Customer numbers (000)	354	352	-0.6%	351	349	-0.6%	347	345	-0.6%
GWAP ($/MWh)	$131.6	$121.1	-8.0%	$104.4	$107.3	2.8%	$92.8	$92.7	0.0%
LWAP/GWAP	1.046	1.043	-0.3%	1.051	1.050	-0.1%	1.056	1.056	0.0%

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:** The value within the electricity sector lies within the generation assets. MCY is the largest North Island generator and its hydro generation is 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 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.

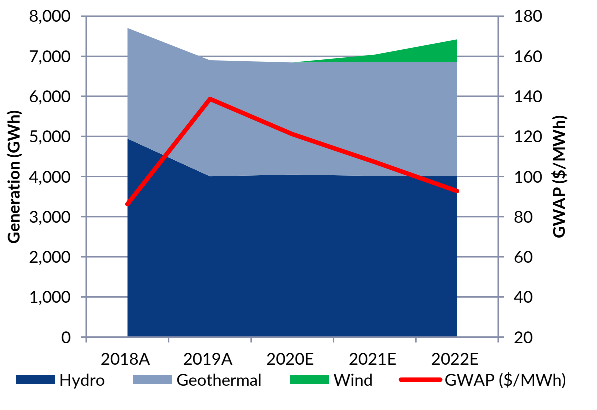
Key risks

- **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 factored into the share price.

Company description

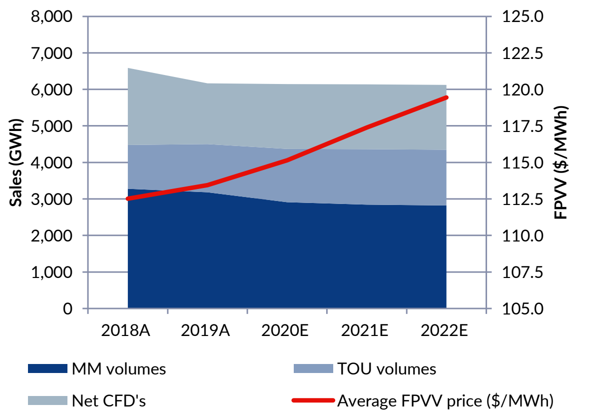
MCY is one of New Zealand's large electricity generator/retailers. It is a 100% renewable generator producing ~6,800GWh of electricity from its North Island based Waikato River hydro power station and geothermal power stations. MCY is developing its first wind farm which is expected to produce ~470GWh 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 3. Generation volumes and average price received



Source: Forsyth Barr analysis

Figure 4. Retail sales volumes and average price received



Source: Forsyth Barr analysis

Figure 5. Substantial Shareholders

Shareholder	Latest Holding
NZ Govt	52.6%

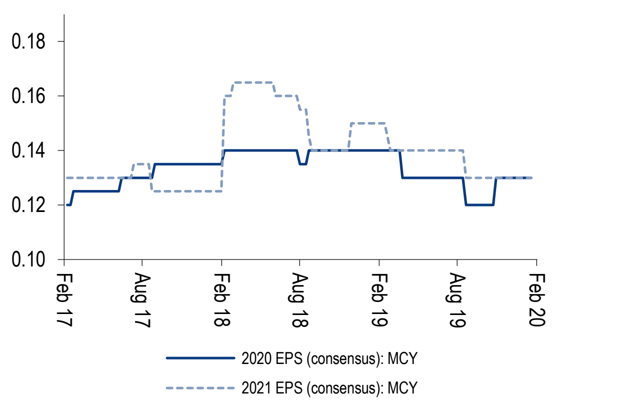
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

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$5.22**	**NZ$7,104**	**29.2x**	**26.2x**	**16.0x**	**15.7x**	**26.1x**	**25.4x**	**3.1%**
Contact Energy *	CEN NZ	NZ$7.42	NZ$5,328	22.9x	20.4x	14.1x	12.9x	25.9x	22.0x	5.3%
Genesis Energy *	GNE NZ	NZ$3.24	NZ$3,335	21.3x	16.8x	12.4x	11.0x	29.3x	23.0x	5.4%
Meridian Energy *	MEL NZ	NZ$5.33	NZ$13,661	26.6x	29.0x	17.5x	18.7x	27.3x	29.8x	4.1%
Trustpower *	TPW NZ	NZ$7.47	NZ$2,338	24.1x	22.5x	14.2x	13.7x	17.5x	16.9x	4.6%
AGL Energy	AGL AT	A$20.24	A$12,933	15.7x	15.7x	7.5x	7.4x	11.4x	11.7x	4.8%
ERM Power	EPW AT	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Origin Energy	ORG AT	A$8.72	A$15,358	14.4x	14.1x	6.5x	6.5x	15.2x	16.0x	4.3%
			Compco Average:	**20.8x**	**19.8x**	**12.0x**	**11.7x**	**21.1x**	**19.9x**	**4.8%**
EV = Current Market Cap + Actual Net Debt			**MCY Relative:**	**+40%**	**+32%**	**+34%**	**+34%**	**+24%**	**+28%**	**-35%**

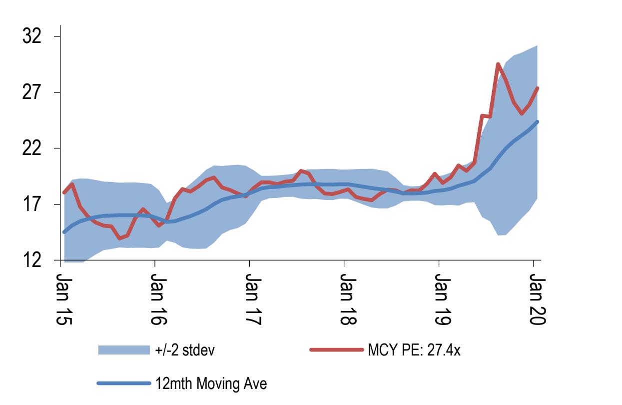
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (MCY) companies fiscal year end

Figure 7. Consensus EPS Momentum



Source: Forsyth Barr analysis, Bloomberg

Figure 8. 12 Month Forward PE



Source: Forsyth Barr analysis