NEW ZEALAND EQUITY RESEARCH | UTILITIES | ELECTRICITY GENERATOR/RETAILER
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Mercury
Return of the Smelter

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UNDERPERFORM

We are upgrading Mercury's (MCY) forecasts materially following the announcement that NZAS will remain open to at least 31 December 2024. NZAS remaining open removes the key downside risk for MCY of a drop in retail prices in reaction to lower wholesale electricity prices. Our medium-term forecast increases are significant, FY22 EBITDAF up +13% and FY23 up +20%. That has flowed through to our dividend forecast (up +9% and +20% in FY22 and FY23 respectively) and our target price, up +NZ$0.48 (+9%) to NZ$5.85. However, MCY's share price performance has been very strong in recent months, with continued ETF-related inflows, hence there is no change to our UNDERPERFORM rating.

NZX Code	MCY
Share price	NZ$6.92
Target price	NZ$5.85
Risk rating	Low
Issued shares	1360.9m
Market cap	NZ$9,417m
Avg daily turnover	765.5k (NZ$3,909k)

Financials: Jun/	20A	21E	22E	23E
NPAT* (NZ$m)	236.1	269.7	294.4	310.3
EPS* (NZc)	17.3	19.8	21.6	22.8
EPS growth* (%)	-1.2	14.2	9.2	5.4
DPS (NZc)	15.8	17.0	18.5	21.6
Imputation (%)	100	100	95	85

*Based on normalised profits

Valuation (x)	20A	21E	22E	23E
PE	39.9	34.9	32.0	30.3
EV/EBIT	36.5	35.7	31.3	29.1
EV/EBITDA	21.5	20.2	18.5	17.6
Price / NTA	2.6	2.6	2.6	2.7
Cash div yld (%)	2.3	2.5	2.7	3.1
Gross div yld (%)	3.2	3.4	3.7	4.2

What's changed?

- **Earnings (EBITDAF):** FY21 +$9m (+2%) to NZ$511m, FY22 +$66m (+13%) to NZ$561m, FY23 +$99m (+20%) to NZ$590m
- **Dividend:** FY21 unchanged at 17.0cps (as per guidance), FY22 +1.5cps (+9%) to 18.5cps, FY23 +3.6cps (+20%) to 21.6cps
- **Target price:** Increased +NZ$0.48 (+8.9%) to NZ$5.85

MCY benefits from no retail price war and firm wholesale electricity prices

MCY's only exposure to NZAS closing was the indirect effects of lower wholesale electricity prices flowing into retail prices. That downside risk is no longer there and with wholesale electricity prices remaining high (the 2022 Otahuhu futures price is above NZ$120/MWh), retail prices are more likely to increase. As a result, there are material increases in our earnings and dividend forecasts. The strong EBITDAF growth in FY22 and FY23 is due to the commissioning of MCY's Turitea wind farm, likely into a period of firm wholesale electricity prices. It is the completion of this wind farm that will enable MCY to grow its dividend faster than its peers in FY22 and FY23.

Improved hydro generation and higher wholesale electricity prices lift FY21 EBITDAF forecast as well

In addition to the improved medium-term outlook, we have also increased our FY21 EBITDAF forecast above MCY's guidance to NZ$511m to due better short-term hydro conditions. December 2022 hydro generation volumes were ~+70GWh (~+23%) above average and its Lake Taupo hydro storage lake is ~+50GWh above average. It helps that wholesale electricity prices are firm, with South Island hydro generation below average and gas production issues continuing to impact the gas-fired thermal generators.

FORSYTH BARR

Mercury NZ Limited (MCY)

Priced as at 15 Jan 2021 (NZ$)	6.92

12-month target price (NZ$)*	5.85
Expected share price return	-15.5%
Net dividend yield	2.6%
Estimated 12-month return	-12.9%

Key WACC assumptions	
Risk free rate	1.30%
Equity beta	0.84
WACC	5.1%
Terminal growth	1.5%

Profit and Loss Account (NZ$m)	2019A	2020A	2021E	2022E	2023E
Sales revenue	2,000.0	1,750.0	1,971.8	2,002.5	1,973.1
Normalised EBITDA	**505.0**	**476.0**	**510.6**	**560.7**	**590.5**
Depreciation and amortisation	(204.0)	(214.0)	(223.0)	(230.8)	(236.2)
Normalised EBIT	**301.0**	**262.0**	**287.6**	**329.9**	**354.3**
Net interest	(75.0)	(54.0)	(54.5)	(61.2)	(65.0)
Associate income	1.0	18.0	1.3	1.7	1.9
Tax	(73.0)	(41.0)	(67.6)	(77.7)	(83.6)
Depreciation capex adj	77.8	72.0	103.0	101.7	102.6
Adjusted normalised NPAT	**239.0**	**236.1**	**269.7**	**294.4**	**310.3**
Abnormals/other	118.0	(29.1)	(103.0)	(101.7)	(102.6)
Reported NPAT	**357.0**	**207.0**	**166.7**	**192.7**	**207.7**
Normalised EPS (cps)	17.6	17.3	19.8	21.6	22.8
DPS (cps)	15.5	15.8	17.0	18.5	21.6

Growth Rates	2019A	2020A	2021A	2022A	2023A
Revenue (%)	11.2	-12.5	12.7	1.6	-1.5
EBITDA (%)	-10.8	-5.7	7.3	9.8	5.3
EBIT (%)	-17.7	-7.3	3.2	14.8	7.4
Normalised NPAT (%)	-6.5	-1.2	14.2	9.2	5.4
Normalised EPS (%)	-6.4	-1.2	14.2	9.2	5.4
Ordinary DPS (%)	2.6	1.9	7.6	8.8	16.8

Cash Flow (NZ$m)	2019A	2020A	2021E	2022E	2023E
EBITDA	**505.0**	**476.0**	**510.6**	**560.7**	**590.5**
Working capital change	2.0	92.0	(24.2)	(45.1)	(11.4)
Interest & tax paid	(148.0)	(136.0)	(146.1)	(153.1)	(159.5)
Other	2.0	(76.0)	0	0	0
Operating cash flow	**361.0**	**356.0**	**340.2**	**362.4**	**419.6**
Capital expenditure	(122.0)	(223.0)	(250.2)	(162.3)	(93.6)
(Acquisitions)/divestments	215.0	0	54.5	0	0
Other	12.0	4.0	(2.4)	(2.6)	(2.9)
Funding available/(required)	**466.0**	**137.0**	**142.2**	**197.5**	**323.1**
Dividends paid	(208.0)	(214.0)	(220.5)	(236.8)	(281.7)
Equity raised/(returned)	0	0	0	0	0
(Increase)/decrease in net debt	**258.0**	**(77.0)**	**(78.3)**	**(39.3)**	**41.4**

Balance Sheet (NZ$m)	2019A	2020A	2021E	2022E	2023E
Working capital	63.0	(14.0)	10.2	55.4	66.8
Fixed assets	5,528.0	5,898.0	5,935.3	5,872.5	5,730.9
Intangibles	62.0	55.0	50.9	48.8	48.0
Right of use asset	0	0	0	0	0
Other assets	521.0	587.0	536.1	540.5	545.3
Total funds employed	**6,174.0**	**6,526.0**	**6,532.5**	**6,517.1**	**6,390.9**
Net debt/(cash)	1,096.0	1,149.0	1,227.3	1,266.5	1,225.2
Lease liability	0	0	0	0	0
Other liabilities	1,498.0	1,575.0	1,557.0	1,546.4	1,535.6
Shareholder's funds	3,580.0	3,802.0	3,748.2	3,704.1	3,630.1
Minority interests	0	0	0	0	0
Total funding sources	**6,174.0**	**6,526.0**	**6,532.5**	**6,517.1**	**6,390.9**

Spot valuations (NZ$)	
1. DCF	5.46
2. Market multiple	5.43
3. Dividend yield	5.99

DCF valuation summary (NZ$m)	
Total firm value	8,712
(Net debt)/cash	(1,277)
Less: Capitalised operating leases	
Value of equity	7,435

Valuation Ratios	2019A	2020A	2021E	2022E	2023E
EV/EBITDA (x)	20.4	21.5	20.2	18.5	17.6
EV/EBIT (x)	34.2	36.5	35.7	31.3	29.1
PE (x)	39.4	39.9	34.9	32.0	30.3
Price/NTA (x)	2.7	2.6	2.6	2.6	2.7
Free cash flow yield (%)	2.5	1.4	1.0	2.1	3.5
Net dividend yield (%)	2.2	2.3	2.5	2.7	3.1
Gross dividend yield (%)	3.1	3.2	3.4	3.7	4.2

Capital Structure	2019A	2020A	2021E	2022E	2023E
Interest cover EBIT (x)	6.7	5.6	5.3	5.4	5.5
Interest cover EBITDA (x)	6.7	8.8	9.4	9.2	9.1
Net debt/ND+E (%)	61.8	63.2	66.6	68.9	71.1
Net debt/EBITDA (x)	2.2	2.4	2.4	2.3	2.1

Key Ratios	2019A	2020A	2021E	2022E	2023E
Return on assets (%)	7.8	4.4	4.2	4.9	5.3
Return on equity (%)	4.6	4.4	4.5	5.3	5.8
Return on funds employed (%)	4.7	3.9	4.2	4.8	5.3
EBITDA margin (%)	25.3	27.2	25.9	28.0	29.9
EBIT margin (%)	15.1	16.0	14.6	16.6	18.1
Capex to sales (%)	6.1	12.7	12.7	8.1	4.7
Capex to depreciation (%)	67	120	127	79	44
Imputation (%)	100	100	100	95	85
Pay-out ratio (%)	88	91	86	86	95

Operating Performance	2019A	2020A	2021E	2022E	2023E
Hydro	4,006	3,708	3,805	4,016	4,016
Geothermal	2,894	2,812	2,839	2,839	2,839
Wind	0	0	52	494	838
Total MCY Generation (GWh)	**6,900**	**6,520**	**6,696**	**7,349**	**7,694**
GWAP ($/MWh)	139	110	142	130	112
Electricity sales					
Electricity customers (000)	373	348	343	349	356
MM volumes	3,182	2,892	2,778	2,799	2,857
TOU volumes	1,319	1,469	1,602	1,750	1,894
Total Fixed Price volumes (GWh)	**4,501**	**4,361**	**4,380**	**4,549**	**4,751**
Spot Sales	780	746	750	753	757
Net CFD's	1,665	1,266	1,703	1,794	1,794
Total Sales (GWh)	**6,946**	**6,373**	**6,833**	**7,096**	**7,302**
Average usage per cust (MWh/yr)	11.8	12.2	12.7	13.1	13.5
LWAP ($/MWh)	145	115	149	137	119
LWAP/GWAP	1.04	1.05	1.05	1.06	1.06
Average FPVV price ($/MWh)	113	118	123	126	127
Line losses (%)	5.1	4.9	5.2	5.1	5.2
Energy margin ($m)	667	652	688	742	774
Operating costs ($m)	(199)	(190)	(192)	(195)	(199)
Other revenue ($m)	37	14	14	14	15
MCY EBITDAF ($m)	**505**	**476**	**511**	**561**	**590**

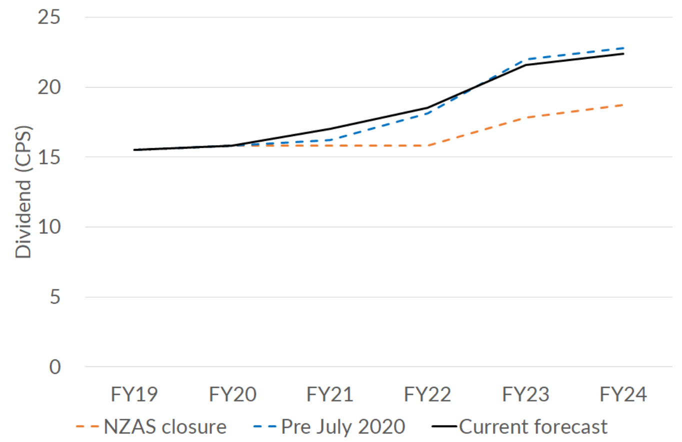
Summary forecast changes

Figure 1. Summary forecast changes

	FY21 Old	FY21 New	% Chg	FY22 Old	FY22 New	% Chg	FY22 Old	FY22 New	% Chg
Sales revenue	1,828	1,956	7.0%	1,592	1,986	24.7%	1,622	1,956	20.6%
Energy margin	679	688	1.3%	675	742	9.8%	675	774	14.7%
EBITDAF	**501**	**511**	**1.8%**	**495**	**561**	**13.4%**	**491**	**590**	**20.2%**
EBIT	280	289	3.3%	270	336	24.5%	257	356	38.6%
Pre-tax profit	225	234	4.1%	208	275	31.9%	190	291	53.3%
NPAT	**160**	**167**	**4.1%**	**149**	**197**	**32.1%**	**135**	**208**	**54.1%**
Normalised NPAT	**160**	**167**	**4.1%**	**145**	**193**	**33.1%**	**135**	**208**	**54.1%**
Dividend (cps)	17.0	17.0	0.0%	17.0	18.5	8.8%	18.0	21.6	20.0%
Generation (GWh)	6,632	6,696	1.0%	7,399	7,349	-0.7%	7,695	7,694	0.0%
FPVV sales (GWh)	4,380	4,380	0.0%	4,549	4,549	0.0%	4,751	4,751	0.0%
Customer numbers (000)	343	343	0.0%	349	349	0.0%	356	356	0.0%
GWAP ($/MWh)	$121.4	$142.2	17.2%	$74.3	$130.0	75.0%	$73.2	$111.8	52.8%
LWAP/GWAP	1.046	1.048	0.2%	1.052	1.057	0.4%	1.062	1.061	-0.1%

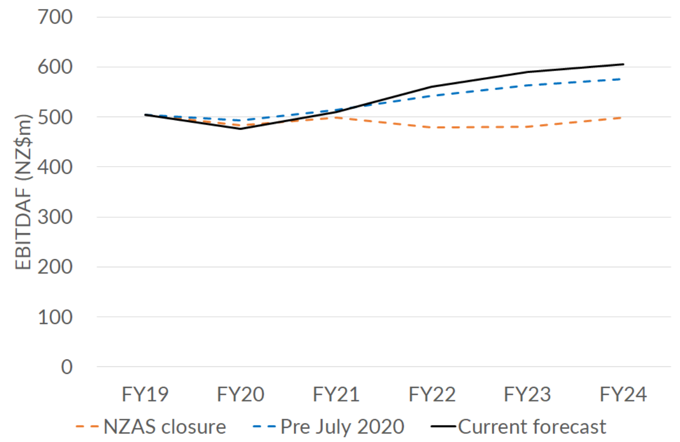
Source: Forsyth Barr analysis

Figure 2. Changes to forecast dividends



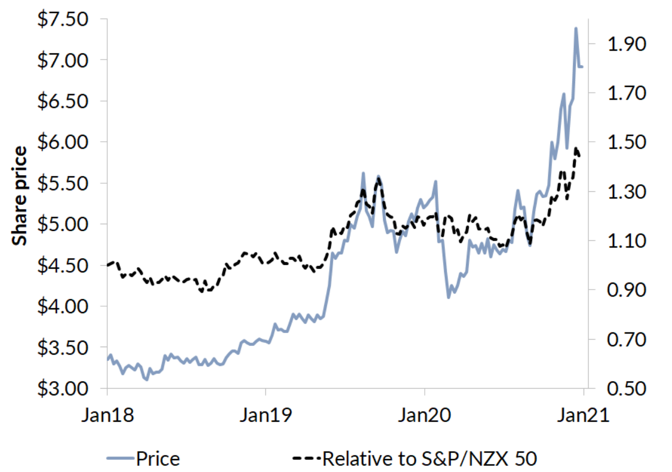
Source: Forsyth Barr analysis

Figure 3. Changes to forecast EBITDAF



Source: Forsyth Barr analysis

Figure 4. Price performance



Source: Forsyth Barr analysis

Figure 5. Substantial shareholders

Shareholder	Latest Holding
NZ Govt	52.6%

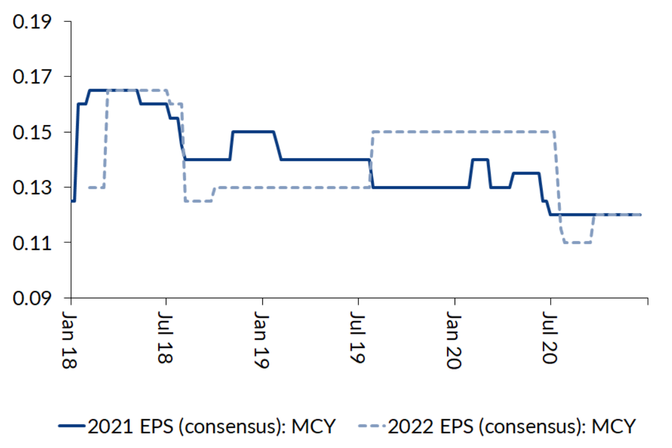
Source: NZX, Forsyth Barr analysis, NOTE: based on SPH notices only

Figure 6. International valuation comparisons

Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash Yld
(metrics re-weighted to reflect MCY's balance date - June)			(m)	2021E	2022E	2021E	2022E	2021E	2022E	2022E
Mercury	**MCY NZ**	**NZ$6.92**	**NZ$9,417**	**34.9x**	**32.0x**	**20.7x**	**18.8x**	**36.6x**	**31.9x**	**2.7%**
CONTACT ENERGY *	CEN NZ	NZ$10.04	NZ$7,214	29.8x	29.9x	18.1x	18.0x	40.8x	36.8x	3.6%
GENESIS ENERGY *	GNE NZ	NZ$3.78	NZ$3,945	20.9x	18.0x	12.8x	11.9x	27.0x	24.4x	4.7%
MERIDIAN ENERGY *	MEL NZ	NZ$8.42	NZ$21,577	48.4x	>50x	30.1x	34.3x	50.1x	62.2x	2.0%
TRUSTPOWER *	TPW NZ	NZ$8.56	NZ$2,679	32.5x	34.3x	17.2x	17.5x	22.5x	23.2x	3.5%
AGL ENERGY	AGL AT	A$12.23	A$7,620	13.8x	19.4x	6.0x	7.1x	10.9x	14.8x	5.0%
ORIGIN ENERGY	ORG AT	A$5.11	A$9,000	22.6x	16.1x	6.4x	5.7x	23.3x	19.6x	4.8%
			Compco Average:	**28.0x**	**23.5x**	**15.1x**	**15.8x**	**29.1x**	**30.2x**	**3.9%**
EV = Current Market Cap + Actual Net Debt			**MCY Relative:**	**25%**	**36%**	**37%**	**20%**	**26%**	**6%**	**-32%**

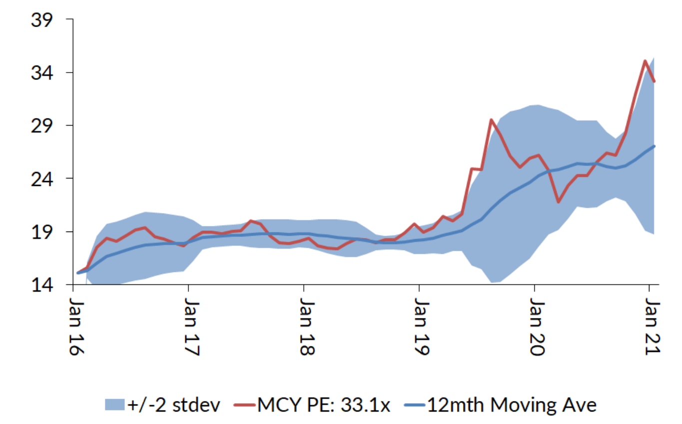
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (MCY) companies fiscal year end

Figure 7. Consensus EPS momentum (NZ$)



Source: Forsyth Barr analysis

Figure 8. One year forward PE (x)



Source: Forsyth Barr analysis

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