

# Mercury

## Trading On Up

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### UNDERPERFORM

Mercury (MCY) has reported strong retail 2Q21 operating statistics, and with a better hydro outlook and strong trading performance has lifted FY21 EBITDAF guidance +NZ\$30m to NZ\$535m. We have increased our FY21 EBITDAF forecast +NZ\$27m to NZ\$538m and raised our target price +15cps (+2.6%) to NZ\$6.00. MCY will be reporting its 1H21 result on Tuesday, 23 February 2021, and we are forecasting a good one, with 1H21 EBITDAF of NZ\$268m, +NZ\$13m higher than 1H20. However, in our view, MCY is expensive and there is no change to our UNDERPERFORM rating.

NZX Code	MCY	Financials: Jun/	20A	21E	22E	23E	Valuation (x)	20A	21E	22E	23E
Share price	NZ\$7.30	NPAT* (NZ\$m)	236.1	289.2	301.4	316.9	PE	42.1	34.3	33.0	31.3
Target price	NZ\$6.00	EPS* (NZc)	17.3	21.3	22.1	23.3	EV/EBIT	38.3	34.2	31.9	29.8
Risk rating	Low	EPS growth* (%)	-1.2	22.5	4.2	5.1	EV/EBITDA	22.5	20.1	19.1	18.2
Issued shares	1360.9m	DPS (NZc)	15.8	17.0	18.5	22.0	Price / NTA	2.7	2.7	2.7	2.8
Market cap	NZ\$9,934m	Imputation (%)	100	100	95	85	Cash div yld (%)	2.2	2.3	2.5	3.0
Avg daily turnover	770.0k (NZ\$3,958k)	*Based on normalised profits					Gross div yld (%)	3.0	3.2	3.5	4.0

#### What's changed and 1H21 result expectation

- **Earnings:** FY21 EBITDAF increased +NZ\$27m (+5.3%) to NZ\$538m (vs. MCY revised guidance of NZ\$535m)
- **Target price:** Increased +15cps (+2.6%) to NZ\$6.00
- **1H21 EBITDAF forecast:** NZ\$268m, an increase of +NZ\$13m (+5.1%) on 1H20
- **Interim dividend forecast:** 6.8cps, an increase of 0.4cps (+6.3%) on 1H20

#### Strong 2Q21 operating statistics

The trends of recent quarters continued in 2Q21 with MCY losing market share in mass market retail, but gaining market share on the commercial side. Total fixed price volumes increased +3.7% to 1,039GWh. The high wholesale electricity prices of the last two years continue to filter through to retail prices with the average retail price increasing +4.0% to NZ\$117.2/MWh. Whilst hydro generation was flat on 2Q20 and below average, good inflow meant MCY's hydro storage position increased ~+200GWh.

#### Guidance upgrade on increased hydro earnings, firm wholesale electricity prices and strong trading performance

MCY has lifted its FY21 EBITDAF guidance +NZ\$30m to NZ\$535m. MCY is citing a +200GWh increase in expected hydro generation to 3,900GWh and a strong trading performance for the uplift. We recently increased our EBITDAF forecast +NZ\$10m to NZ\$511m (and hydro generation forecast ~+100GWh to ~+3,800GWh). Whilst we were right directionally, the magnitude of the upgrade is more than anticipated. Having gone through a dry sequence earlier in FY21, MCY will be able to sell the extra hydro generation at high wholesale electricity prices. We have lifted our FY21 EBITDAF forecast +NZ\$27m to NZ\$538m which includes an extra 100GWh of hydro generation, plus a better retail performance as signalled by the 2Q21 operating statistics.

#### Expecting a strong 1H21 result

We are forecasting 1H21 EBITDAF of NZ\$268m, +NZ\$13m up on the 1H20 result. The main drivers of the expected increase in earnings are 1) improved retail performance, with total sales up +2.4% (due to a strong increase in commercial sales, which are up +25%) and the average selling price increasing +5.7% and 2) a strong trading performance, as mentioned by MCY. Generation volumes are down -108GWh, with hydro generation down -168GWh.

## Mercury NZ Limited (MCY)

Priced as at 22 Jan 2021 (NZ\$) **7.30**

<b>12-month target price (NZ\$)*</b>	<b>6.00</b>
Expected share price return	-17.8%
Net dividend yield	2.4%
Estimated 12-month return	-15.4%

<b>Key WACC assumptions</b>	
Risk free rate	1.30%
Equity beta	0.84
WACC	5.1%
Terminal growth	1.5%

<b>Spot valuations (NZ\$)</b>	
1. DCF	5.59
2. Market multiple	5.78
3. Dividend yield	5.99

<b>DCF valuation summary (NZ\$m)</b>	
Total firm value	8,883
(Net debt)/cash	(1,277)
Less: Capitalised operating leases	
Value of equity	7,606

<b>Profit and Loss Account (NZ\$m)</b>	<b>2019A</b>	<b>2020A</b>	<b>2021E</b>	<b>2022E</b>	<b>2023E</b>
Sales revenue	2,000.0	1,750.0	1,922.9	1,973.8	1,957.1
<b>Normalised EBITDA</b>	<b>505.0</b>	<b>476.0</b>	<b>538.1</b>	<b>569.8</b>	<b>598.5</b>
Depreciation and amortisation	(204.0)	(214.0)	(223.0)	(230.8)	(236.2)
<b>Normalised EBIT</b>	<b>301.0</b>	<b>262.0</b>	<b>315.1</b>	<b>339.0</b>	<b>362.4</b>
Net interest	(75.0)	(54.0)	(54.9)	(60.6)	(63.9)
Associate income	1.0	18.0	1.3	1.7	1.9
Tax	(73.0)	(41.0)	(75.2)	(80.4)	(86.1)
Depreciation capex adj	77.8	72.0	103.0	101.7	102.6
<b>Adjusted normalised NPAT</b>	<b>239.0</b>	<b>236.1</b>	<b>289.2</b>	<b>301.4</b>	<b>316.9</b>
Abnormals/other	118.0	(29.1)	(103.0)	(101.7)	(102.6)
<b>Reported NPAT</b>	<b>357.0</b>	<b>207.0</b>	<b>186.3</b>	<b>199.7</b>	<b>214.3</b>
Normalised EPS (cps)	17.6	17.3	21.3	22.1	23.3
DPS (cps)	15.5	15.8	17.0	18.5	22.0

<b>Growth Rates</b>	<b>2019A</b>	<b>2020A</b>	<b>2021A</b>	<b>2022A</b>	<b>2023A</b>
Revenue (%)	11.2	-12.5	9.9	2.6	-0.8
EBITDA (%)	-10.8	-5.7	13.0	5.9	5.0
EBIT (%)	-17.7	-7.3	13.0	7.7	6.9
Normalised NPAT (%)	-6.5	-1.2	22.5	4.2	5.1
Normalised EPS (%)	-6.4	-1.2	22.5	4.2	5.1
Ordinary DPS (%)	2.6	1.9	7.6	8.8	18.9

<b>Cash Flow (NZ\$m)</b>	<b>2019A</b>	<b>2020A</b>	<b>2021E</b>	<b>2022E</b>	<b>2023E</b>
<b>EBITDA</b>	<b>505.0</b>	<b>476.0</b>	<b>538.1</b>	<b>569.8</b>	<b>598.5</b>
Working capital change	2.0	92.0	(35.2)	(36.9)	(10.6)
Interest & tax paid	(148.0)	(136.0)	(154.1)	(155.3)	(161.0)
Other	2.0	(76.0)	0	0	0
<b>Operating cash flow</b>	<b>361.0</b>	<b>356.0</b>	<b>348.8</b>	<b>377.7</b>	<b>427.0</b>
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)
<b>Funding available/(required)</b>	<b>466.0</b>	<b>137.0</b>	<b>150.8</b>	<b>212.8</b>	<b>330.5</b>
Dividends paid	(208.0)	(214.0)	(220.5)	(236.8)	(288.5)
Equity raised/(returned)	0	0	0	0	0
<b>(Increase)/decrease in net debt</b>	<b>258.0</b>	<b>(77.0)</b>	<b>(69.7)</b>	<b>(24.0)</b>	<b>42.0</b>

<b>Balance Sheet (NZ\$m)</b>	<b>2019A</b>	<b>2020A</b>	<b>2021E</b>	<b>2022E</b>	<b>2023E</b>
Working capital	63.0	(14.0)	21.2	58.0	68.6
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	540.4	545.2
<b>Total funds employed</b>	<b>6,174.0</b>	<b>6,526.0</b>	<b>6,543.4</b>	<b>6,519.7</b>	<b>6,392.8</b>
Net debt/(cash)	1,096.0	1,149.0	1,218.7	1,242.7	1,200.7
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	3,767.8	3,730.7	3,656.4
Minority interests	0	0	0	0	0
<b>Total funding sources</b>	<b>6,174.0</b>	<b>6,526.0</b>	<b>6,543.4</b>	<b>6,519.7</b>	<b>6,392.8</b>

<b>Valuation Ratios</b>	<b>2019A</b>	<b>2020A</b>	<b>2021E</b>	<b>2022E</b>	<b>2023E</b>
EV/EBITDA (x)	21.5	22.5	20.1	19.1	18.2
EV/EBIT (x)	35.9	38.3	34.2	31.9	29.8
PE (x)	41.6	42.1	34.3	33.0	31.3
Price/NTA (x)	2.9	2.7	2.7	2.7	2.8
Free cash flow yield (%)	2.4	1.3	1.0	2.2	3.4
Net dividend yield (%)	2.1	2.2	2.3	2.5	3.0
Gross dividend yield (%)	2.9	3.0	3.2	3.5	4.0

<b>Capital Structure</b>	<b>2019A</b>	<b>2020A</b>	<b>2021E</b>	<b>2022E</b>	<b>2023E</b>
Interest cover EBIT (x)	6.7	5.6	5.8	5.6	5.7
Interest cover EBITDA (x)	6.7	8.8	9.8	9.4	9.4
Net debt/ND+E (%)	61.8	63.2	65.7	67.5	69.6
Net debt/EBITDA (x)	2.2	2.4	2.3	2.2	2.0

<b>Key Ratios</b>	<b>2019A</b>	<b>2020A</b>	<b>2021E</b>	<b>2022E</b>	<b>2023E</b>
Return on assets (%)	7.8	4.4	4.6	5.0	5.5
Return on equity (%)	4.6	4.4	5.0	5.4	6.0
Return on funds employed (%)	4.7	3.9	4.6	5.0	5.4
EBITDA margin (%)	25.3	27.2	28.0	28.9	30.6
EBIT margin (%)	15.1	16.0	16.5	17.3	18.6
Capex to sales (%)	6.1	12.7	13.0	8.2	4.8
Capex to depreciation (%)	67	120	127	79	44
Imputation (%)	100	100	100	95	85
Pay-out ratio (%)	88	91	80	84	94

<b>Operating Performance</b>	<b>2019A</b>	<b>2020A</b>	<b>2021E</b>	<b>2022E</b>	<b>2023E</b>
Hydro	4,006	3,708	3,894	4,016	4,016
Geothermal	2,894	2,812	2,852	2,838	2,838
Wind	0	0	52	494	838
<b>Total MCY Generation (GWh)</b>	<b>6,900</b>	<b>6,520</b>	<b>6,798</b>	<b>7,348</b>	<b>7,692</b>
GWAP (\$/MWh)	139	110	136	130	115

<b>Electricity sales</b>	<b>2019A</b>	<b>2020A</b>	<b>2021E</b>	<b>2022E</b>	<b>2023E</b>
Electricity customers (000)	373	348	329	333	339
MM volumes	3,182	2,892	2,701	2,641	2,686
TOU volumes	1,319	1,469	1,812	2,079	2,178
<b>Total Fixed Price volumes (GWh)</b>	<b>4,501</b>	<b>4,361</b>	<b>4,514</b>	<b>4,721</b>	<b>4,864</b>
Spot Sales	780	746	214	215	216
Net CFD's	1,665	1,266	1,821	1,924	1,924
<b>Total Sales (GWh)</b>	<b>6,946</b>	<b>6,373</b>	<b>6,549</b>	<b>6,859</b>	<b>7,003</b>
Average usage per cust (MWh/yr)	11.8	12.2	13.4	14.3	14.5
LWAP (\$/MWh)	145	115	144	137	122
LWAP/GWAP	1.04	1.05	1.06	1.06	1.06
Average FPV price (\$/MWh)	113	118	124	127	128
Line losses (%)	5.1	4.9	4.9	4.9	4.9
Energy margin (\$m)	667	652	716	751	782
Operating costs (\$m)	(199)	(190)	(192)	(195)	(199)
Other revenue (\$m)	37	14	14	14	15
<b>MCY EBITDAF (\$m)</b>	<b>505</b>	<b>476</b>	<b>538</b>	<b>570</b>	<b>599</b>

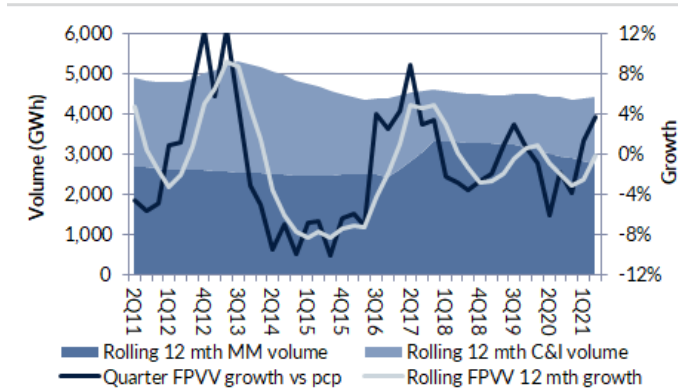
## 2Q21 operating statistics

Figure 1. 2Q21 operating statistics

	Dec-19 2Q20	Dec-20 2Q21	% Chg	Comments
<b>Fixed price, variable vol. (FPVV) (GWh)</b>				
Mass market (MM)	663	606	-8.6%	Decline mainly due to lower connection numbers
Commercial & ind. (C&I)	339	433	27.7%	Growth in commercial volumes similar to recent quarters, more than offsetting mass market declines
<b>Total FPVV sales</b>	<b>1,002</b>	<b>1,039</b>	<b>3.7%</b>	
Financial sales	833	935	12.2%	Increase in financial sales contracts effectively matched by increased financial purchases
<b>Total sales volumes</b>	<b>1,835</b>	<b>1,974</b>	<b>7.6%</b>	
<b>Customer numbers</b>				
Customer numbers	356,000	336,000	-5.6%	Big fall in connections vs. pcip as MCY continues focus on margin over volume
Cust. adds in the quarter	-5,000	-6,000		Cust declines continued in 2Q21 - we expect this level of decline to start easing within the next 12 months
MM vol/cust (MWh/cust)	1.85	1.79	-3.3%	Modest drop in per customer volumes, in line with decline in national demand
MM price (\$/MWh)	129.4	139.4	7.7%	Big lift in margin vs. pcip, partly due to lines charge declines, partly margin focus
C&I price (\$/MWh)	79.9	86.2	7.9%	Strong price increase as firm ASX futures prices continue to feed into higher C&I prices
<b>FPVV sales price</b>	<b>112.6</b>	<b>117.2</b>	<b>4.0%</b>	Mix change in favour of commercial contracts means FPVV increase is less than mass market or commercial
LWAP (\$/MWh)	109.5	120.2	9.8%	
<b>Generation (GWh)</b>				
Hydro	928	930	0.2%	Hydro generation almost identical to 2Q20, but still below average
Geothermal	596	659	10.6%	Geothermal generation up due to maintenance in 2Q20
<b>Total</b>	<b>1,524</b>	<b>1,589</b>	<b>4.3%</b>	
Hydro diff to average	(97)	(95)		Soft hydro conditions continue, but good inflows sees storage increase +200GWh
GWAP (\$/MWh)	103.5	114.5	10.6%	Continued strong wholesale prices due to below avg South Island hydro storage and gas supply issues
LWAP/GWAP (physical)	1.058	1.050	-0.8%	

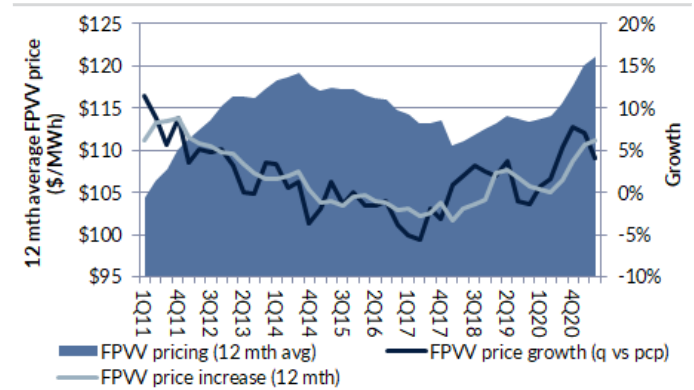
Source: MCY, Forsyth Barr analysis

Figure 2. Retail sales volumes



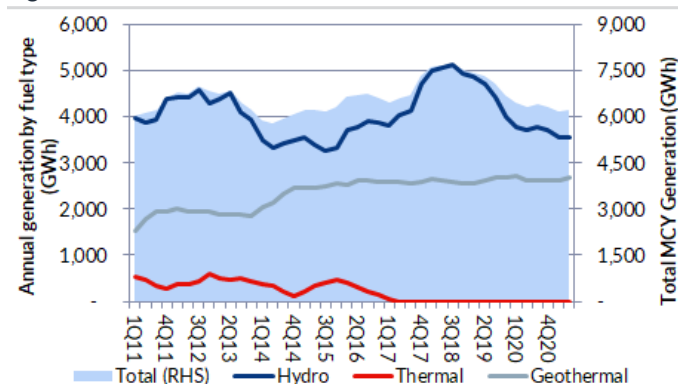
Source: MCY, Forsyth Barr analysis

Figure 3. Retail sales price



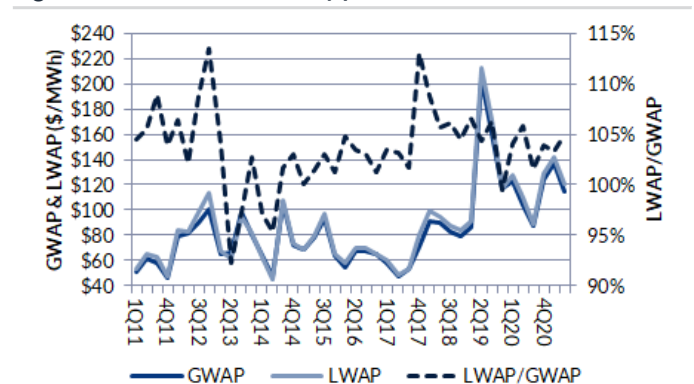
Source: MCY, Forsyth Barr analysis

Figure 4. Generation volumes



Source: MCY, Forsyth Barr analysis

Figure 5. Wholesale electricity prices and LWAP/GWAP ratio



Source: MCY, Forsyth Barr analysis

## Forecast changes

Figure 6. Forecast changes

NZ\$m	FY21 Old	FY21 New	% Chg	FY22 Old	FY22 New	% Chg	FY23 Old	FY23 New	% Chg
Sales revenue	1,956	1,907	-2%	1,986	1,957	-1%	1,956	1,940	-1%
Cost of sales	(1,267)	(1,191)	-6%	(1,244)	(1,207)	-3%	(1,182)	(1,158)	-2%
<b>Energy margin</b>	<b>688</b>	<b>716</b>	<b>4%</b>	<b>742</b>	<b>751</b>	<b>1%</b>	<b>774</b>	<b>782</b>	<b>1%</b>
Other income	14	14	0%	14	14	0%	15	15	0%
Other operating costs	(192)	(192)	0%	(195)	(195)	0%	(199)	(199)	0%
<b>EBITDAF</b>	<b>511</b>	<b>538</b>	<b>5%</b>	<b>561</b>	<b>570</b>	<b>2%</b>	<b>590</b>	<b>599</b>	<b>1%</b>
Depn & amort	(223)	(223)	0%	(231)	(231)	0%	(236)	(236)	0%
FV mvmts, assoc inc, other	1	1	-1%	6	6	0%	2	2	0%
<b>EBIT</b>	<b>289</b>	<b>316</b>	<b>10%</b>	<b>336</b>	<b>345</b>	<b>3%</b>	<b>356</b>	<b>364</b>	<b>2%</b>
Net interest	(55)	(55)	1%	(61)	(61)	-1%	(65)	(64)	-2%
<b>Pre-tax profit</b>	<b>234</b>	<b>261</b>	<b>12%</b>	<b>275</b>	<b>284</b>	<b>4%</b>	<b>291</b>	<b>300</b>	<b>3%</b>
Tax	(68)	(75)	11%	(78)	(80)	3%	(84)	(86)	3%
<b>NPAT</b>	<b>167</b>	<b>186</b>	<b>12%</b>	<b>197</b>	<b>204</b>	<b>4%</b>	<b>208</b>	<b>214</b>	<b>3%</b>
Dividend (cps) (incl specials)	17.0	17.0	0%	18.5	18.5	0%	21.6	22.0	2%
<b>Operating statistics</b>			Diff			Diff			Diff
Generation (GWh)	6,696	6,798	1.5%	7,349	7,348	0.0%	7,694	7,692	0.0%
FPVV sales (GWh)	4,380	4,514	3.0%	4,549	4,721	3.8%	4,751	4,864	2.4%
Customer numbers (000)	342.8	329.3	-3.9%	349.5	332.6	-4.8%	355.6	338.8	-4.7%
GWAP (\$/MWh)	\$142.2	\$135.7	-4.6%	\$130.0	\$129.9	0.0%	\$111.8	\$115.4	3.2%
LWAP/GWAP	1.048	1.058	1.0%	1.057	1.057	0.0%	1.061	1.061	0.0%

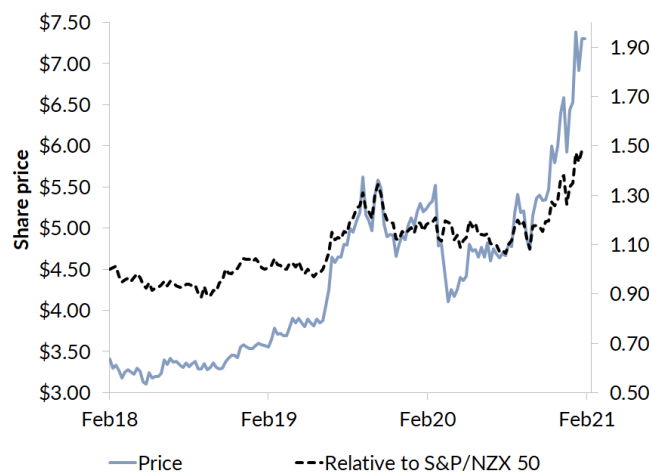
Source: Forsyth Barr analysis

## 1H21 forecast

Figure 7. 1H21 forecast (6 months to 31 December 2020)

	1H20 NZ \$m	1H21 NZ \$m	% Chg
Sales revenue	917	934	2%
Cost of sales	(575)	(578)	0%
<b>Energy margin</b>	<b>342</b>	<b>356</b>	<b>4%</b>
Other revenue	7	7	1%
Other operating costs	(94)	(95)	1%
<b>EBITDAF</b>	<b>255</b>	<b>269</b>	<b>5%</b>
Depn & amort	(105)	(112)	7%
<b>EBIT</b>	<b>150</b>	<b>157</b>	<b>4%</b>
FV mvmts, assoc inc, other	(19)	(0)	-98%
Net interest	(30)	(28)	-8%
<b>Pre-tax profit</b>	<b>101</b>	<b>129</b>	<b>27%</b>
Tax	(18)	(37)	106%
<b>NPAT</b>	<b>83</b>	<b>92</b>	<b>10%</b>
<b>Normalised NPAT</b>	<b>90</b>	<b>92</b>	<b>2%</b>
EPS (cps)	6.6	6.7	2%
Dividend (cps)	6.4	6.8	6%
<b>Operating statistics</b>			
Generation (GWh)	3,524	3,415	-3%
FPVV sales (GWh)	2,242	2,296	2%
Customer numbers	356,000	336,000	-6%
GWAP (\$/MWh)	\$114	\$124	9%

Source: Forsyth Barr analysis

**Figure 8. Price performance**


Source: Forsyth Barr analysis

**Figure 9. Substantial shareholders**

Shareholder	Latest Holding
NZ Govt	52.6%

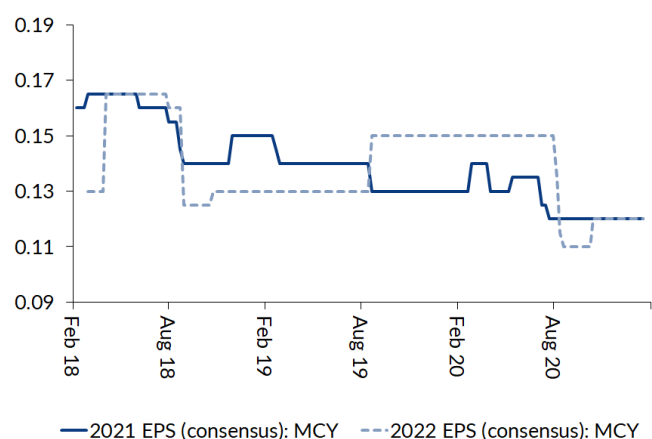
Source: NZX, Forsyth Barr analysis, NOTE: based on SPH notices only

**Figure 10. International valuation comparisons**

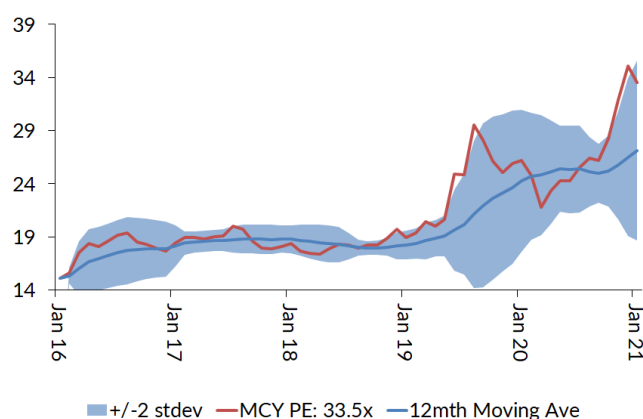
Company	Code	Price	Mkt Cap (m)	PE 2021E	PE 2022E	EV/EBITDA 2021E	EV/EBITDA 2022E	EV/EBIT 2021E	EV/EBIT 2022E	Cash Yld 2022E
(metrics re-weighted to reflect MCY's balance date - June)										
Mercury	MCY NZ	NZ\$7.30	NZ\$9,934	34.3x	33.0x	20.6x	19.5x	35.0x	32.5x	2.5%
CONTACT ENERGY *	CEN NZ	NZ\$9.18	NZ\$6,596	27.1x	27.2x	16.7x	16.6x	37.8x	34.0x	3.9%
GENESIS ENERGY *	GNE NZ	NZ\$3.60	NZ\$3,757	19.9x	17.1x	12.4x	11.5x	26.0x	23.5x	4.9%
MERIDIAN ENERGY *	MEL NZ	NZ\$7.44	NZ\$19,066	47.2x	46.4x	28.9x	27.9x	50.9x	47.3x	2.3%
TRUSTPOWER *	TPW NZ	NZ\$8.75	NZ\$2,739	32.6x	28.5x	17.3x	15.7x	22.6x	20.1x	3.9%
AGL ENERGY	AGL AT	A\$11.86	A\$7,389	13.7x	19.5x	6.0x	7.0x	10.7x	14.7x	5.0%
ORIGIN ENERGY	ORG AT	A\$5.07	A\$8,929	21.7x	16.1x	6.4x	5.8x	22.6x	20.1x	4.8%
Compco Average:				27.0x	25.8x	14.6x	14.1x	28.4x	26.6x	4.1%
MCY Relative:				27%	28%	41%	38%	23%	22%	-39%

EV = Current Market Cap + Actual Net Debt

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

**Figure 11. Consensus EPS momentum (NZ\$)**


Source: Forsyth Barr analysis

**Figure 12. One year forward PE (x)**


Source: Forsyth Barr analysis

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