

Meridian Energy

UNDERPERFORM

Off to a Flier — 1Q20 Operating Performance

Meridian Energy's (MEL) remarkable operational performance has continued into FY20 and we estimate EBITDAF is tracking ~+NZ\$45m ahead of the pcp. We are upgrading our FY20 EBITDAF forecast +NZ\$61m to NZ\$820m as we expect the favourable conditions to continue for a period yet. Whilst we have lifted our target price +5cps to \$4.25, we retain our UNDERPERFORM rating as MEL remains the most expensive generator/retailer in the market.

What's changed?

- **Earnings:** FY20 EBITDAF increased +\$61m to \$820m
- **Target Price:** Increased +5cps to \$4.25
- **Rating:** UNDERPERFORM rating retained

Strong beginning in New Zealand, but weak in Australia

MEL has started FY20 where it ended FY19. We estimate that 1Q20 EBITDAF is NZ\$257m, +NZ\$45m ahead of the pcp with New Zealand operating conditions continuing to be favourable. Retail volumes (+17%), average retail prices (+2.4%), generation volumes (+3.6%) and generation prices (+47%) are all tracking well ahead of the pcp. We calculate the NZ Energy margin for 1Q20 was NZ\$320m, +NZ\$54m up on the pcp.

However, the strong NZ performance is offset by weaker Australian figures. Difficult retail conditions and the continued drought have impacted on earnings. We estimate the 1Q20 Australian Energy Margin was A\$32m, -A\$6m (-NZ\$8m) lower than the pcp. In addition, operating costs are tracking well ahead of last year (although MEL had signalled this).

Earnings upgrade based on 1Q20 performance and expected strong conditions for the remainder of 1H20

We have lifted our FY20 EBITDAF forecast +NZ\$61m to NZ\$820m. The driver of the uplift is the strong start and the expectation the next few months will continue to be favourable for MEL. That said, we note all of the outperformance is expected in 1H20, with 2H20 facing some transmission related headwinds. In addition, we have lowered our Australian contribution.

We have lifted our dividend forecast modestly (+0.2cps in FY20 to 21.6cps) which is a reflection of MEL's "above average" FY19 dividend meaning we are not passing more of the earnings upgrade into the dividend.

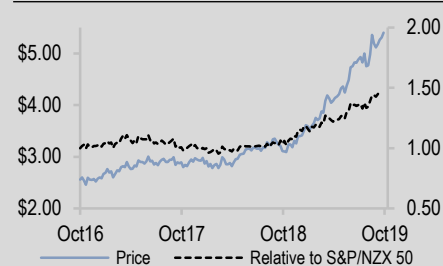
Our +5cps target price is modest as the short-term earnings uplift only equates to ~+1.5cps, and our longer-term forecasts, whilst increasing, have not increased materially.

Investment View

Our rating is UNDERPERFORM. Whilst MEL is a high quality stock, in our view it offers less value than alternative electricity generator/retailers. Short-term trading conditions have been strong, highlighted by the FY19 result and start to FY20. However, underlying earnings are materially lower than what current operating results indicate.

NZX Code	MEL
Share price	NZ\$5.40
Target price	NZ\$4.25
Risk rating	Low
Issued shares	2563.0m
Market cap	NZ\$13,840m
Average daily turnover	1,360k (NZ\$5,624k)

Share Price Performance



Financials: June	19A	20E	21E	22E
NPAT* (NZ\$m)	481.3	479.7	439.8	448.7
EPS* (NZc)	18.8	18.7	17.2	17.5
EPS growth* (%)	33.4	-0.3	-8.3	2.0
DPS (NZc)	21.3	21.6	21.8	20.9
Imputation (%)	66	65	65	70

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	18.2	18.7	19.9	19.5
EV/EBIT	27.2	30.0	32.8	31.3
PE	28.8	28.9	31.5	30.8
Price / NTA	2.6	2.7	2.8	n/a
Cash dividend yield (%)	3.9	4.0	4.0	3.9
Gross dividend yield (%)	5.0	5.0	5.1	4.9

*Historic and forecast numbers based on underlying profits

Andrew Harvey-Green

andrew.harvey-green@forsythbarr.co.nz

+64 4 495 8185

Meridian Energy Limited (MEL)

Priced as at 17 Oct 2019: NZ\$5.40

June year end

Forsyth Barr valuation					Valuation Ratios						
Valuation methodology					2018A 2019A 2020E 2021E 2022E						
Mix of market multiple and DCF					EV/EBITDA (x)	22.7	18.2	18.7	19.9	19.5	
					EV/EBIT (x)	38.1	27.2	30.0	32.8	31.3	
					PE (x)	38.4	28.8	28.9	31.5	30.8	
					Price/NTA (x)	2.9	2.6	2.7	2.8	3.0	
					Free cash flow yield (%)	1.3	4.1	3.6	3.3	3.5	
					Net dividend yield (%)	3.6	3.9	4.0	4.0	3.9	
					Gross dividend yield (%)	4.5	5.0	5.0	5.1	4.9	
					Imputation (%)	68	66	65	65	70	
					Pay-out ratio (%)	136	113	115	127	120	
Key WACC assumptions					Capital Structure						
DCF valuation summary (NZ\$m)					2018A 2020E 2021E 2022E						
Risk free rate	2.00%	Total firm value			11,597	Interest cover EBIT (x)	4.7	6.6	6.1	5.4	5.5
Equity beta	0.84	(Net debt)/cash			(1,761)	Interest cover EBITDA (x)	8.2	10.1	10.1	9.3	9.2
WACC	6.7%	Value of equity			9,836	Net debt/ND+E (%)	23.2	20.7	22.2	24.3	26.4
Terminal growth	1.5%	Shares (m)			2,563	Net debt/EBITDA (x)	2.2	1.7	1.8	2.1	2.1
Profit and Loss Account (NZ\$m)					Key Ratios						
2018A 2019A 2020E 2021E 2022E					2018A 2019A 2020E 2021E 2022E						
Sales revenue	3,297	4,104	3,746	3,546	3,504	Return on assets (%)	4.4	5.7	5.3	4.9	5.3
Normalised EBITDA	666	838	820	769	786	Return on equity (%)	4.3	6.1	5.7	5.4	6.0
Depreciation and amortisation	(268)	(276)	(309)	(302)	(296)	Return on funds employed (%)	4.6	5.9	5.5	5.2	5.6
Normalised EBIT	398	562	510	467	490	EBITDA margin (%)	20.2	20.4	21.9	21.7	22.4
Net interest	(81)	(83)	(81)	(83)	(86)	EBIT margin (%)	12.1	13.7	13.6	13.2	14.0
Associate income & other	(19)	(14)	(17)	(19)	(19)	Capex to sales (%)	7.5	1.7	2.0	2.2	1.7
Tax	(95)	(133)	(115)	(102)	(108)	Capex to depreciation (%)	100	28	27	27	21
Minority interests	-	-	-	-	-	Operating Statistics					
Reported NPAT	203	332	297	263	277	2018A 2019A 2020E 2021E 2022E					
Abnormals/other	158	149	183	177	171	Hydro generation	11,266	12,326	11,967	11,701	11,701
Adjusted normalised NPAT	361	481	480	440	449	Wind generation	1,263	1,244	1,470	1,474	1,474
Adjusted normalised EPS (cps)	14.1	18.8	18.7	17.2	17.5	Total NZ generation (GWh)	12,528	13,570	13,436	13,175	13,175
DPS (cps)	19.2	21.3	21.6	21.8	20.9	GWAP (\$/MWh)	83.0	123.3	115.4	99.2	90.7
Growth Rates					Overseas generation (GWh)						
2018A 2019A 2020E 2021E 2022E					2018A 2019A 2020E 2021E 2022E						
Revenue (%)	16.7	24.5	-8.7	-5.3	-1.2	Overseas GWAP (\$/MWh) (NZD)	151	100	137	105	96
EBITDA (%)	1.4	25.8	-2.2	-6.2	2.3	Overseas customer numbers (000)	97	110	127	143	153
EBIT (%)	1.3	41.2	-9.2	-8.5	4.9	Powershop customers (000)	66	74	80	82	83
Normalised NPAT (%)	-3.1	33.4	-0.3	-8.3	2.0	Meridian branded customers (000)	225	228	235	240	245
Normalised EPS (%)	-3.1	33.4	-0.3	-8.3	2.0	NZ electricity customers (000)	291	302	315	321	328
DPS (%)	1.5	10.9	1.2	1.1	-3.9	Average usage per cust (MWh/yr)	13.5	13.2	12.9	12.9	12.9
Cash Flow (NZ\$m)					Mass market volumes						
2018A 2019A 2020E 2021E 2022E					2018A 2019A 2020E 2021E 2022E						
EBITDA	666	838	820	769	786	Time of use volumes	2,157	2,338	2,721	2,742	2,764
Working capital change	(34)	(36)	7	13	16	Total fixed price volumes (GWh)	5,981	6,239	6,710	6,836	6,944
Interest & tax paid	(186)	(200)	(238)	(226)	(235)	NZAS sales	5,011	5,310	5,464	5,449	5,449
Other	(19)	33	(17)	(19)	(19)	Sell CFDs	2,278	2,239	1,967	1,967	1,967
Operating cash flow	427	635	572	537	548	Buy CFDs	-2,222	-1,965	-1,938	-1,740	-1,740
Capital expenditure	(247)	(69)	(75)	(76)	(58)	Total Sales (GWh)	11,047	11,823	12,202	12,511	12,619
(Acquisitions)/divestments	23	-	-	-	-	Average FPV price (\$/MWh)	105.2	104.8	106.8	108.7	110.5
Other	-	-	-	-	-	LWAP (\$/MWh)	88	132	124	106	98
Funding available/(required)	203	566	496	461	490	LWAP/GWAP	1.06	1.07	1.08	1.07	1.08
Dividends paid	(486)	(500)	(552)	(558)	(570)	Lines losses (%)	5.3	5.9	5.5	5.5	5.5
Equity raised/(returned)	(2)	(2)	-	-	-	New Zealand Energy Margin (\$m)	944	1,108	1,080	1,019	1,023
Increase/(decrease) in net debt	285	(64)	56	98	80	Overseas Energy Margin (\$m)	86	118	118	114	114
Balance Sheet (NZ\$m)					Meridian Energy Margin (\$m)						
2018A 2019A 2020E 2021E 2022E					2018A 2019A 2020E 2021E 2022E						
Working capital	(17)	(24)	(14)	(8)	(5)	1,030	1,226	1,199	1,133	1,137	
Fixed assets	7,941	8,825	8,599	8,377	8,139						
Intangibles	60	59	51	47	47						
Other assets	291	383	366	347	328						
Total funds employed	8,275	9,243	9,002	8,763	8,509						
Net debt/(cash)	1,461	1,424	1,480	1,578	1,658						
Other non current liabilities	1,991	2,362	2,321	2,280	2,238						
Shareholder's funds	4,823	5,457	5,201	4,906	4,613						
Minority interests	-	-	-	-	-						
Total funding sources	8,275	9,243	9,002	8,763	8,509						

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

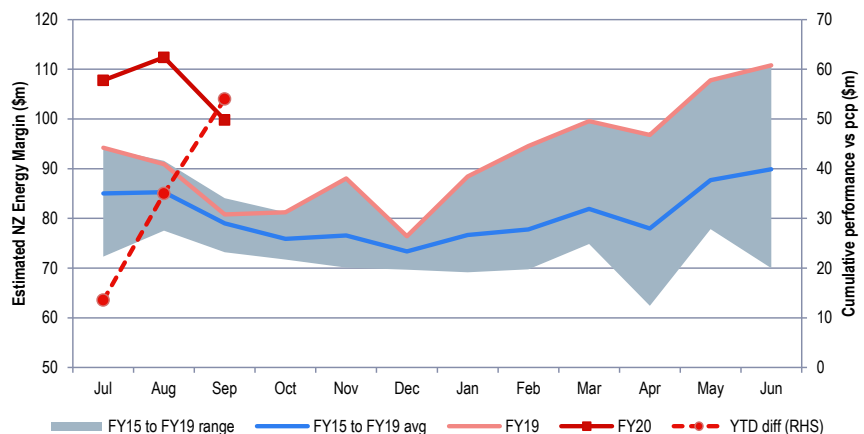
1Q20 operating performance

Figure 1. Estimated operating performance breakdown

	Sep-18	Sep-19	Diff	YTD	YTD	Diff
	\$m	\$m	\$m	Sep-18	Sep-19	\$m
NZ retail revenue	85	104	19	291	333	42
NZ hedging gain/loss (incl mkt costs)	2	6	3	6	19	13
NZ generation/wholesale performance	(7)	(10)	(4)	(31)	(33)	(1)
Estimated NZ Energy Margin	81	100	19	266	320	54
Aus retail contribution (A\$m)	2	1	(2)	9	5	(4)
Aus hedging gain/loss (incl mkt costs) (A\$m)	0	0	0	0	1	1
Aus generation/wholesale performance (A\$m)	9	9	(1)	30	26	(4)
Estimated Aus Energy Margin (A\$m)	11	9	(2)	38	32	(6)
Estimated Aus Energy Margin (NZ\$m)	13	10	(2)	41	33	(8)
Operating costs	(24)	(25)	(1)	(69)	(73)	(4)
Est. transmission costs	(11)	(11)	0	(33)	(32)	0
Est. other revenue	2	3	1	7	9	2
Estimated MEL EBITDAF (NZ\$m)	61	77	16	212	257	45

Source: MEL, Forsyth Barr analysis

Figure 2. Historic estimated NZ Energy Margin



Source: MEL, Forsyth Barr analysis

Summary forecast changes

Figure 3. Forecast changes

	FY20			FY21			FY21		
	Old	New	% Chg	Old	New	% Chg	Old	New	% Chg
NZ Energy Margin	1,022	1,080	5.7%	1,013	1,019	0.6%	1,013	1,023	1.0%
Australia Energy Margin	124	118	-4.8%	115	114	-0.5%	114	114	0.0%
EBITDAF	769	820	6.6%	766	769	0.4%	779	786	0.9%
EBIT	460	510	11.0%	464	467	0.6%	483	490	1.5%
Pre-tax profit	360	412	14.4%	360	365	1.5%	375	385	2.6%
NPAT	259	297	14.4%	259	263	1.5%	270	277	2.6%
Dividend (cps)	21.4	21.6	0.8%	21.6	21.8	1.0%	20.6	20.9	1.7%
NZ Generation (GWh)	13,494	13,436	-0.4%	13,175	13,175	0.0%	13,175	13,175	0.0%
FPVV sales (GWh)	6,460	6,710	3.9%	6,523	6,836	4.8%	6,627	6,944	4.8%
Customer numbers (000)	302	315	4.3%	308	321	4.3%	315	328	4.3%
GWAP (\$/MWh)	\$102.5	\$115.4	12.5%	\$94.9	\$99.2	4.6%	\$90.6	\$90.7	0.1%

Source: Forsyth Barr analysis

Investment summary

Our rating is **UNDERPERFORM**. Whilst MEL is a high quality stock, in our view it offers less value than alternative electricity generator/retailers. Short-term trading conditions have been strong, highlighted by the FY19 result, albeit we do not expect a repeat of that performance.

Business quality

- **Low risk, modest growth industry:** Electricity demand is relatively inelastic and the industry is well positioned to benefit from New Zealand decarbonising transport and industrial processes.
- **Strong generation position:** Most of the generation value within the electricity sector lies within the generation assets. MEL is the largest generator in New Zealand, producing ~32% of New Zealand's electricity requirements and controls ~50% of New Zealand's hydro storage. Its hydro generation portfolio means it is the lowest cost generator.
- **Track record:** Since listing in 2014, MEL has demonstrated an ability to unlock value and has lifted operating earnings +25%.

Earnings and cash flow outlook

- **More modest growth after FY19:** We expect earnings growth to slow after the stellar FY19 year (although early indications are positive for FY20). We expect transmission benefits to be offset by a gradually declining wholesale electricity price.
- **Cash flow strong in near-term:** Limited electricity demand growth means capital expenditure is limited, resulting in strong free cash flows.

Company description

Meridian is New Zealand's largest electricity generator/retailer. It produces ~11,500GWh of electricity from its South Island hydro power stations and ~1,500GWh from its predominantly North Island wind farms. MEL's retail brands, Meridian and Powershop retail electricity to around 290,000 customers. MEL also has an international presence in Australia owning two wind farms and has launched its Powershop retail brand in Victoria and NSW. MEL's largest customer is New Zealand's largest power user, the Tiwai Point aluminium smelter which consumes ~13% of New Zealand's power and ~40% of MEL's output.

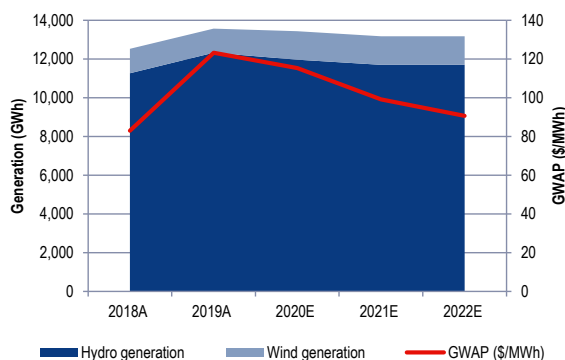
Financial structure

- **Balance sheet:** Management recognises that surplus cash is better with shareholders than the business. MEL currently has spare capacity on its balance sheet and hence it has in place a capital management plan that will gradually lift gearing in the business.
- **Dividends:** MEL's strong free cash flow enables it to pay high dividends, which are currently elevated due to the capital management plan.

Key risks

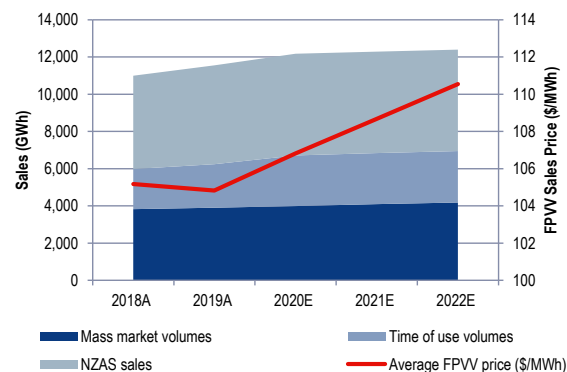
- **Regulatory risk:** The 2014 election highlighted the political/regulatory risks inherent in the sector. Whilst the Electricity Price Review creates some uncertainty, we believe there is as much upside as downside risk, and in any case is unlikely to have a material impact on MEL.
- **Rising bond yields:** In recent years MEL has traded in line with bond yields. A lift in interest rates is likely to see MEL trade lower.

Figure 4. Generation volumes and average generation price



Source: MEL, Forsyth Barr analysis

Figure 5. Sales volumes and average sales price



Source: MEL, Forsyth Barr analysis

Figure 6. Substantial Shareholders

Shareholder	Latest Holding
NZ Govt	51.0%

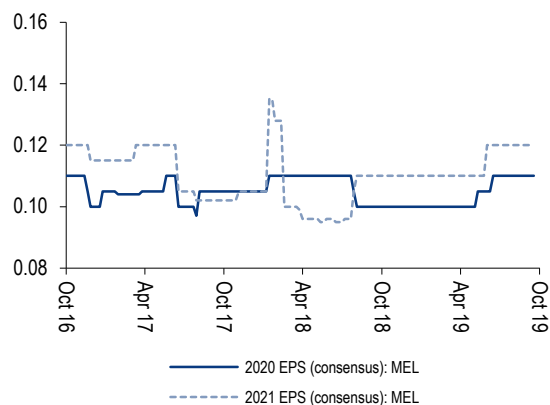
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 7. International Compcos

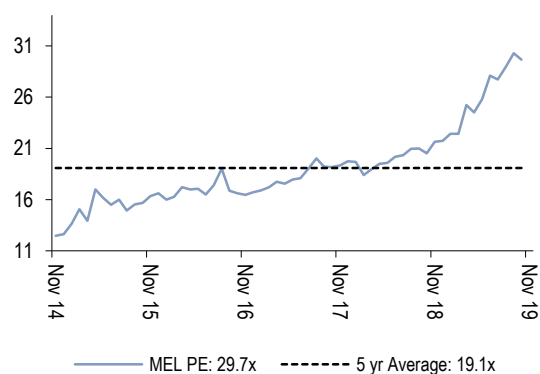
Company <i>(metrics re-weighted to reflect MEL's balance date - June)</i>	Code	Price	Mkt Cap (m)	PE		EV/EBITDA		EV/EBIT		Cash D/Yld
				2020E	2021E	2020E	2021E	2020E	2021E	2021E
Meridian Energy	MEL NZ	NZ\$5.40	NZ\$13,840	28.9x	31.5x	18.6x	19.8x	29.9x	32.7x	4.0%
Contact Energy *	CEN NZ	NZ\$8.67	NZ\$6,223	24.9x	23.4x	15.3x	14.6x	27.1x	24.7x	4.6%
Genesis Energy *	GNE NZ	NZ\$3.39	NZ\$3,470	22.1x	17.8x	12.7x	11.5x	29.8x	24.2x	5.2%
Mercury *	MCY NZ	NZ\$5.50	NZ\$7,493	32.8x	27.6x	17.6x	16.4x	29.9x	27.1x	2.9%
Trustpower *	TPW NZ	NZ\$8.21	NZ\$2,570	24.4x	23.9x	14.9x	14.5x	18.7x	18.2x	4.3%
AGL Energy	AGL AT	A\$19.45	A\$12,709	15.1x	15.1x	7.3x	7.3x	11.2x	11.4x	5.0%
ERM Power	EPW AT	A\$2.40	A\$601	12.0x	16.1x	7.1x	6.7x	10.1x	9.5x	4.2%
Infigen Energy	IFN AT	A\$0.69	A\$664	14.7x	19.7x	7.1x	8.1x	11.5x	14.2x	2.9%
Origin Energy	ORG AT	A\$8.12	A\$14,301	13.8x	13.0x	6.3x	6.2x	15.1x	14.7x	4.5%
Compcpo Average:				20.0x	19.6x	11.0x	10.7x	19.2x	18.0x	4.2%
MEL Relative:				+45%	+61%	+69%	+86%	+56%	+82%	-4%

EV = Current Market Cap + Actual Net Debt

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

Figure 8. Consensus EPS Momentum


Source: Forsyth Barr analysis, Bloomberg

Figure 9. 12 Month Forward PE


Source: Forsyth Barr analysis

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