

Meridian Energy

NEUTRAL

One in Twenty Year Rain Event

Meridian Energy's (MEL) incredible run continues with its hydro storage lakes almost doubling in the past four weeks, with only a very wet November 1999 getting anywhere close. In addition, its deal to accelerate the removal of lower South Island transmission constraints and finalised 2020–2024 transmission prices lower than expected mean it has been a good month for MEL. We have upgraded our FY20 EBITDAF forecast +\$36m to \$852m, lifted our target price +14cps to \$4.25, but maintain our NEUTRAL rating.

What's changed?

- **Earnings:** FY20 EBITDAF increased +\$36m (+4.4%) to \$852m
- **Target Price:** Increased +14cps (+3.4%) to \$4.25
- **Rating:** NEUTRAL rating retained

Pukaki close to full, Manapouri spilling water

MEL's hydro storage is particularly strong. In the past four weeks storage has increased +1,069GWh, a twenty year high. Hydro storage is +832GWh above average for this time of year and snow storage is estimated to be +185GWh above average — putting MEL into a very strong position for the remainder of FY20.

Deal to relieve lower South Island transmission constraints a positive

MEL and Contact Energy have paid \$5m each to Transpower in order for it to start work earlier than it otherwise would have on relieving lower South Island transmission constraints. Whilst the transmission lines will only constrain in the event the aluminium smelter (NZAS) closes, it is a significant positive as it materially reduces the amount of lost hydro generation if NZAS were to close. In addition, it improves MEL's negotiating position with NZAS (and the North Island generators). We have lowered our NZAS risk adjustment 1cps to -7cps.

Australia proving to be tough going

Whilst the New Zealand operation is performing well, Australia is struggling in comparison. The year-to-date (to end of October 2019) Australia Energy Margin is -NZ\$8m below the pcp, with a combination of the drought and regulatory price caps lowering earnings.

FY20 earnings uplift on hydro position, FY21 increased too

We have increased our FY20 EBITDAF forecast +\$36m to \$852m (which is now higher than the remarkable record FY19). Driving the uplift is the increase in hydro storage and the relatively muted response in the wholesale electricity market. Partially offsetting the increase is higher operating costs (up +\$12m including the \$5m payment to Transpower) and a lower Australia contribution (down -\$5m). Looking ahead to FY21, we anticipate that MEL will start FY21 with above average water levels, which combined with lower than expected transmission costs, has increased our FY21 EBITDAF forecast +\$26m to \$778m. We have also increased our target price +14cps (+3.4%) to \$4.25.

Investment View

Our rating is NEUTRAL. MEL has been the strongest electricity performer in recent years and its low cost generation assets provides it with a strong defensive position. Its dividend yield is attractive, although we expect that will fall in FY22 when the current capital management programme ends.

NZX Code	MEL
Share price	NZ\$5.00
Target price	NZ\$4.25
Risk rating	Low
Issued shares	2563.0m
Market cap	NZ\$12,815m
Average daily turnover	1,523k (NZ\$6,702k)

Share Price Performance



Financials: June	19A	20E	21E	22E
NPAT* (NZ\$m)	481.3	505.4	449.4	438.8
EPS* (NZc)	18.8	19.7	17.5	17.1
EPS growth* (%)	33.4	5.0	-11.1	-2.4
DPS (NZc)	21.3	21.5	21.8	20.6
Imputation (%)	66	65	65	70

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	17.0	16.7	18.3	18.6
EV/EBIT	25.4	26.3	30.0	30.3
PE	26.6	25.4	28.5	29.2
Price / NTA	2.4	2.5	2.6	n/a
Cash dividend yield (%)	4.3	4.3	4.4	4.1
Gross dividend yield (%)	5.4	5.4	5.5	5.2

*Historic and forecast numbers based on underlying profits

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Forecast changes

Figure 1. Forecast changes

	FY20	FY20		FY21	FY21		FY22	FY22	
	Old	New	Chg	Old	New	Chg	Old	New	Chg
	\$m	\$m	%	\$m	\$m	%	\$m	\$m	%
NZ Energy Margin	1,077	1,127	4.6%	1,001	1,034	3.2%	1,004	1,014	1.0%
Australia Energy Margin	118	113	-4.2%	114	102	-11.3%	114	100	-12.6%
Energy margin	1,195	1,240	3.7%	1,116	1,135	1.7%	1,118	1,113	-0.4%
Other revenue	32	32	0.0%	35	35	0.0%	35	35	0.0%
Transmission costs	(123)	(119)	-2.9%	(104)	(89)	-14.2%	(96)	(83)	-13.6%
Operating costs	(288)	(300)	4.3%	(295)	(303)	2.6%	(290)	(298)	2.7%
EBITDAF	816	852	4.4%	752	778	3.5%	767	768	0.1%
Depn & amort	(309)	(309)	0.0%	(302)	(302)	0.0%	(296)	(296)	0.0%
EBIT	507	543	7.1%	450	476	5.9%	470	471	0.2%
Net interest	(81)	(78)	-3.8%	(83)	(78)	-5.7%	(87)	(81)	-6.7%
FV mvmts, assoc inc, other	(17)	(17)	0.0%	(19)	(19)	0.0%	(19)	(19)	0.0%
Pre-tax profit	409	448	9.6%	347	379	9.0%	365	371	1.8%
Tax	(114)	(125)	9.6%	(97)	(106)	9.0%	(102)	(104)	1.8%
NPAT	294	322	9.6%	250	273	9.0%	263	267	1.8%
FB adjusted NPAT	477	505	5.9%	427	449	5.3%	434	439	1.1%
Dividend (cps)	21.5	21.5	0.1%	21.6	21.8	0.7%	20.4	20.6	0.9%
Normalised EPS	11.5	12.6	9.6%	9.8	10.6	9.0%	10.2	10.4	1.8%
Operating statistics			Diff			Diff			Diff
NZ generation (GWh)	13,436	14,256	6.1%	13,175	13,354	1.4%	13,175	13,175	0.0%
FPVV sales (GWh)	6,710	6,869	2.4%	6,836	6,997	2.4%	6,944	7,107	2.3%
Cust. numbers (000)	315	315	0.0%	321	321	0.0%	328	328	0.0%
GWAP (\$/MWh)	\$114.0	\$99.8	-12.4%	\$96.4	\$99.4	3.1%	\$85.8	\$83.7	-2.4%

Source: Forsyth Barr analysis

Investment summary

Our rating is NEUTRAL. MEL has been the strongest electricity performer in recent years and its low cost generation assets provides it with a strong defensive position. Its dividend yield is attractive, although we expect that will fall in FY22 when the current capital management programme ends.

Business quality

- **Low risk, modest growth industry:** Electricity demand is inelastic and the industry is well positioned to benefit from NZ electrifying transport and industrial processes.
- **Strong generation position:** Most of the 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 and controls ~50% of New Zealand's hydro storage. It is also 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

- **Earnings fall after FY20:** We expect earnings to fall in FY21 after two remarkable years of well above average hydro generation and high wholesale electricity prices. 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.

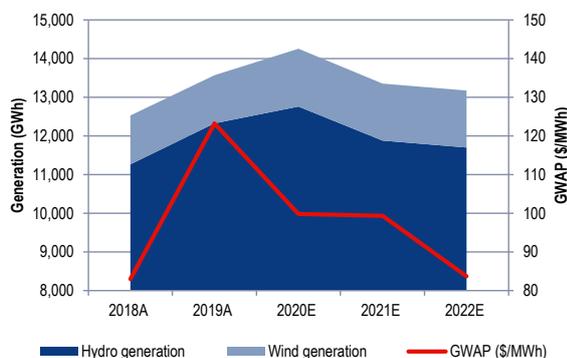
Financial structure

- **Balance sheet:** Management recognises that surplus cash is better with shareholders. MEL currently has spare capacity on its balance sheet and has in place a capital management plan that is gradually lifting gearing.
- **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

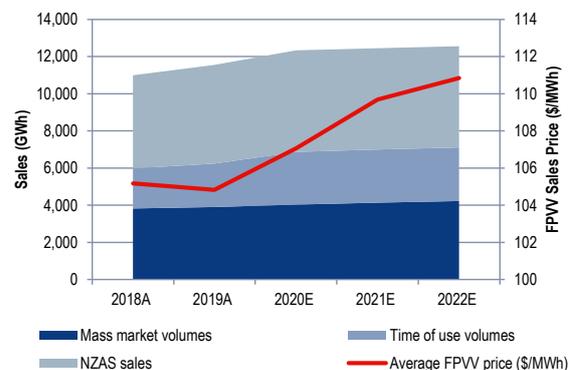
- **Political/regulatory:** The 2014 election and recent Electricity Price Review (EPR) highlighted the political/regulatory risks inherent in the sector. Whilst the EPR gave the sector a thumbs up in most areas, the political risk is unlikely to ever disappear.
- **NZAS risk:** NZAS has indicated it 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.

Figure 2. Generation volumes and average price received



Source: MEL, Forsyth Barr analysis

Figure 3. Sales volumes and average price received (excl NZAS)



Source: MEL, Forsyth Barr analysis

Figure 4. Substantial Shareholders

Shareholder	Latest Holding
NZ Govt	51.0%

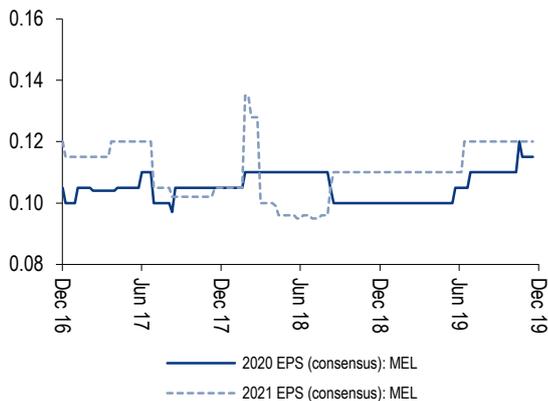
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 5. International Compcos

Company	Code	Price	Mkt Cap (m)	PE		EV/EBITDA		EV/EBIT		Cash D/Yld
				2020E	2021E	2020E	2021E	2020E	2021E	2021E
<i>(metrics re-weighted to reflect MEL's balance date - June)</i>										
Meridian Energy	MEL NZ	NZ\$5.00	NZ\$12,815	25.4x	28.5x	16.7x	18.3x	26.2x	29.9x	4.4%
Contact Energy *	CEN NZ	NZ\$7.19	NZ\$5,161	20.0x	19.2x	12.8x	12.3x	22.1x	20.8x	5.5%
Genesis Energy *	GNE NZ	NZ\$3.09	NZ\$3,181	20.3x	16.0x	12.0x	10.7x	28.3x	22.3x	5.7%
Mercury *	MCY NZ	NZ\$4.78	NZ\$6,512	26.1x	23.5x	14.7x	14.4x	24.2x	23.5x	3.4%
Trustpower *	TPW NZ	NZ\$7.21	NZ\$2,257	23.2x	21.7x	13.8x	13.3x	17.1x	16.4x	4.8%
AGL Energy	AGL AT	A\$20.24	A\$13,055	15.6x	15.6x	7.5x	7.5x	11.5x	11.6x	4.9%
ERM Power	EPW AT	A\$2.41	A\$603	12.5x	15.4x	7.0x	6.6x	10.0x	9.3x	4.4%
Infigen Energy	IFN AT	A\$0.63	A\$606	14.0x	19.1x	6.9x	7.8x	11.1x	13.9x	3.2%
Origin Energy	ORG AT	A\$8.53	A\$15,023	14.3x	13.8x	6.4x	6.4x	15.7x	15.5x	4.5%
Compcos Average:				18.3x	18.1x	10.1x	9.9x	17.5x	16.7x	4.5%
EV = Current Market Cap + Actual Net Debt				MEL Relative:	+39%	+58%	+65%	+85%	+50%	+80%
										-4%

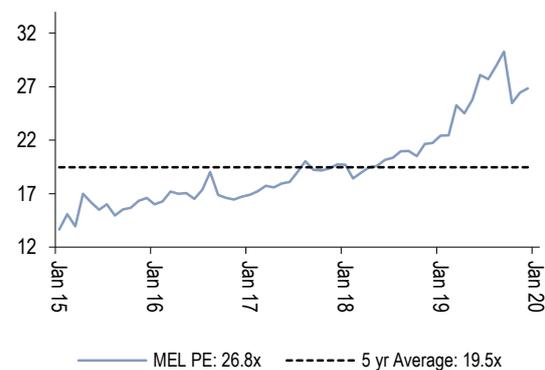
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compcos metrics re-weighted to reflect headline (MEL) companies fiscal year end

Figure 6. Consensus EPS Momentum



Source: Forsyth Barr analysis, Bloomberg

Figure 7. 12 Month Forward PE



Source: Forsyth Barr analysis

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