FORSYTH BARR

Meridian Energy

NEUTRAL

Retail & Water Boost Earnings Again — Dec 2019 Operating Stats

Another month and another strong operating performance from Meridian Energy (MEL) with the December 2019 estimated NZ Energy Margin breaking another record. We estimate that the December NZ Energy Margin was $96m, +$19m ahead of the pcp and taking the 1H20 NZ Energy Margin +$90m ahead of the pcp. MEL is well on track to beat its record FY19 result, and we are upgrading our FY20 EBITDAF forecast +$11m to $863m (+1.2%) and our target price +15cps (+3.5%) to $4.40.

What's changed?

- **Earnings:** FY20 EBITDAF increased +$11m (+1.2%) to $863m
- **Target Price:** Increased +15cps (+3.5%) to $4.40
- **Rating:** NEUTRAL rating retained

Big increase in retail sales at a good price

The main drivers of MEL's strong NZ December 2019 performance were:

- +45% increase in retail sales volumes at a +4.7% higher average price vs. pcp. The increase in retail sales was boosted by weak December 2018 volumes vs. Dec 2017; sales volumes are up a more modest +10%.
- Generation volumes were up +21% on the pcp following the heavy rain in late November/early December. The strong generation volumes enabled MEL to be long generation.

Australia steady

We estimate that the Australian Energy Margin was A$10m, +$2m up on the pcp, with the retail performance improving sufficiently to offset weaker Australian generation (due to weaker prices).

Forecasting 1H20 EBITDAF of $466m

Our 1H20 EBITDAF forecast is $466m, +$77m higher than the pcp and +$17m higher than 2H19. MEL's run of strong months has continued — it has now had 15 consecutive months ahead of the pcp. However, we do not expect the strong run to stretch into 2H20 as MEL starts to lap very strong 2H19 monthly performance and planned HVDC outages hamper 2H20 earnings.

Lifting forecasts further on rising retail margins and better Australian contribution

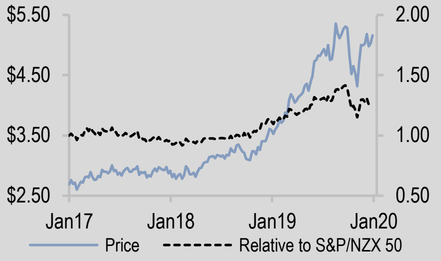
We have increased our FY20 EBITDAF forecast +$9m (+1.2%) to $863m as December 2019 was once again better than expected. Longer-dated earnings have also increased +$30m (+3.8%) and +$38m (+5.0%) in FY21/FY22 respectively. The drivers of the earnings increases are stronger retail sales volumes and prices (increased +1.8% and +0.4%) and a stronger Australian contribution as MEL grows its retail base faster than previously forecast.

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$5.16
Target price	NZ$4.40
Risk rating	Low
Issued shares	2563.0m
Market cap	NZ$13,225m
Avg daily turnover	1,478k (NZ$6,723k)

Share Price Performance



Financials	19A	20E	21E	22E
NPAT* (NZ$m)	481.3	513.3	471.7	468.0
EPS* (NZc)	18.8	20.0	18.4	18.3
EPS growth* (%)	33.4	6.7	-8.1	-0.8
DPS (NZc)	21.3	21.5	21.9	21.2
Imputation (%)	66	65	65	70

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	17.5	17.0	18.2	18.2
EV/EBIT	26.1	26.5	29.0	28.8
PE	27.5	25.8	28.0	28.3
Price / NTA	2.4	2.6	2.7	n/a
Cash div yld (%)	4.1	4.2	4.2	4.1
Gross div yld (%)	5.2	5.2	5.3	5.2

*Historic/forecast numbers based on normalised profits

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Meridian Energy Limited (MEL)

Priced as at 15 Jan 2020 (NZ$)	**5.16**

12-month target price (NZ$)*	**4.40**
Expected share price return	-14.7%
Net dividend yield	4.2%
Estimated 12-month return	-10.5%

Spot valuations (NZ$)	
1. DCF	3.73
2. Market multiple	4.72
3. Dividend yield	4.62

Key WACC assumptions	
Risk free rate	2.00%
Equity beta	0.84
WACC	6.8%
Terminal growth	1.5%

DCF valuation summary (NZ$m)	
Total firm value	11,324
(Net debt)/cash	(1,761)
Less: Capitalised operating leases	
Value of equity	9,563

Profit and Loss Account (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Sales revenue	3,297	4,104	3,580	3,596	3,478
Normalised EBITDA	**666**	**838**	**863**	**808**	**806**
Depreciation and amortisation	(21)	(276)	(309)	(302)	(296)
Normalised EBIT	**398**	**562**	**553**	**506**	**510**
Net interest	(81)	(83)	(78)	(77)	(79)
Associate income & other	(19)	(14)	(17)	(19)	(19)
Tax	(95)	(133)	(128)	(115)	(115)
Minority interests	-	-	-	-	-
Reported NPAT	**203**	**332**	**330**	**295**	**297**
Abnormals/other	158	149	183	177	171
Adjusted normalised NPAT	**361**	**481**	**513**	**472**	**468**
Normalised EPS (cps)	14.1	18.8	20.0	18.4	18.3
DPS (cps)	19.2	21.3	21.5	21.9	21.2

Valuation Ratios	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EV/EBITDA (x)	21.8	17.5	17.0	18.2	18.2
EV/EBIT (x)	36.5	26.1	26.5	29.0	28.8
PE (x)	36.7	27.5	25.8	28.0	28.3
Price/NTA (x)	2.8	2.4	2.6	2.7	2.8
Free cash flow yield (%)	1.4	4.3	3.9	3.8	3.8
Net dividend yield (%)	3.7	4.1	4.2	4.2	4.1
Gross dividend yield (%)	4.7	5.2	5.2	5.3	5.2

Capital Structure	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Interest cover EBIT (x)	4.7	6.6	6.9	6.3	6.2
Interest cover EBITDA (x)	8.2	10.1	11.1	10.4	10.2
Net debt/ND+E (%)	71.3	76.9	87.5	103.7	126.3
Net debt/EBITDA (x)	2.2	1.7	1.7	1.9	1.9

Growth Rates	**2018A**	**2019A**	**2020A**	**2021A**	**2022A**
Revenue (%)	16.7	24.5	-12.8	0.5	-3.3
EBITDA (%)	1.4	25.8	3.0	-6.4	-0.3
EBIT (%)	1.3	41.2	-1.5	-8.6	0.7
Normalised NPAT (%)	-3.1	33.4	6.7	-8.1	-0.8
Normalised EPS (%)	-3.1	33.4	6.7	-8.1	-0.8
Ordinary DPS (%)	1.5	10.9	1.1	1.8	-3.2

Key Ratios	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Return on assets (%)	4.4	5.7	5.7	5.4	5.5
Return on equity (%)	4.3	6.1	6.3	5.9	6.3
Return on funds employed (%)	4.6	5.9	6.0	5.6	5.8
EBITDA margin (%)	20.2	20.4	24.1	22.5	23.2
EBIT margin (%)	12.1	13.7	15.5	14.1	14.7
Capex to sales (%)	7.5	1.7	2.1	2.1	1.7
Capex to depreciation (%)	n/a	28	27	27	21
Imputation (%)	68	66	65	65	70
Pay-out ratio (%)	136	113	107	119	116

Cash Flow (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EBITDA	**666**	**838**	**863**	**808**	**806**
Working capital change	(34)	(36)	(4)	24	14
Interest & tax paid	(186)	(200)	(247)	(233)	(236)
Other	(19)	33	(17)	(19)	(19)
Operating cash flow	**427**	**635**	**595**	**580**	**565**
Capital expenditure	(247)	(69)	(75)	(76)	(58)
(Acquisitions)/divestments	23	-	-	-	-
Other	-	-	-	-	-
Funding available/(required)	**203**	**566**	**519**	**503**	**507**
Dividends paid	(486)	(500)	(551)	(557)	(569)
Equity raised/(returned)	(2)	(2)	-	-	-
(Increase)/decrease in net debt	**(285)**	**64**	**(32)**	**(53)**	**(62)**

Operating Performance	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Hydro generation	11,266	12,326	12,626	11,946	11,701
Wind generation	1,263	1,244	1,491	1,474	1,474
Total NZ generation (GWh)	**12,528**	**13,570**	**14,117**	**13,419**	**13,175**
GWAP ($/MWh)	83	123	97	98	87
Overseas generation (GWh)	581	730	698	809	809
Overseas GWAP ($/MWh) (NZD)	151	100	136	102	92
Overseas customer numbers (000	97	110	133	150	161
NZ electricity customers (000)	**291**	**302**	**317**	**323**	**330**
Average usage per cust (MWh/yr)	13.5	13.2	13.3	13.2	13.2
Mass market volumes	3,824	3,901	4,116	4,226	4,315
Time of use volumes	2,157	2,338	2,874	2,897	2,921
Total fixed price volumes (GWh)	**5,981**	**6,239**	**6,990**	**7,124**	**7,236**
NZAS sales	5,011	5,310	5,464	5,449	5,449
Sell CFDs	2,278	2,239	1,756	1,806	1,806
Buy CFDs	(2,222)	(1,965)	(1,988)	(1,790)	(1,790)
Total Sales (GWh)	**11,047**	**11,823**	**12,222**	**12,588**	**12,701**
Average FPVV price ($/MWh)	105	105	107	110	111
LWAP ($/MWh)	88	132	106	105	93
LWAP/GWAP	1.06	1.07	1.09	1.07	1.07
Lines losses (%)	5.3	5.9	5.1	5.5	5.5

Balance Sheet (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Working capital	(17)	(24)	(3)	(8)	(3)
Fixed assets	7,941	8,825	8,599	8,377	8,139
Intangibles	60	59	51	47	47
Right of use asset	-	-	-	-	-
Other assets	291	383	366	347	328
Total funds employed	**8,275**	**9,243**	**9,013**	**8,763**	**8,511**
Net debt/(cash)	1,461	1,424	1,456	1,509	1,571
Lease liability	-	-	-	-	-
Other liabilities	1,991	2,362	2,321	2,280	2,238
Shareholder's funds	4,823	5,457	5,236	4,975	4,702
Minority interests	-	-	-	-	-
Total funding sources	**8,275**	**9,243**	**9,013**	**8,763**	**8,511**

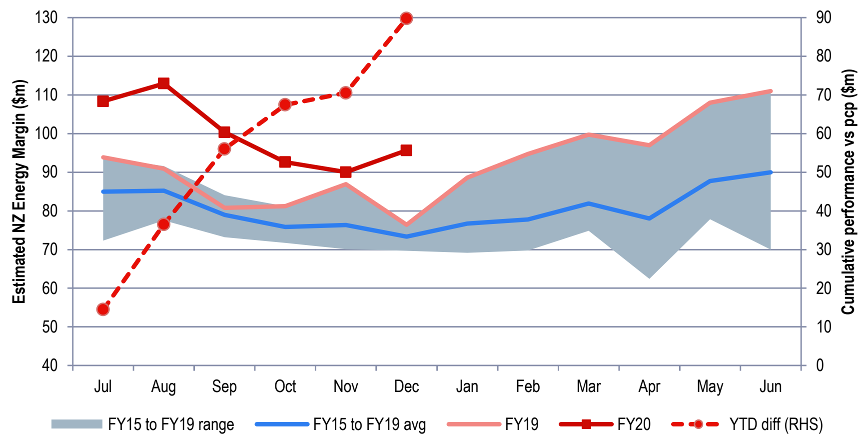
December 2019 Operating Performance

Figure 1. Estimated EBITDAF breakdown

	Dec-18 $m	Dec-19 $m	Diff $m	YTD Dec-18 $m	YTD Dec-19 $m	Diff $m
NZ retail revenue	90	104	**14**	561	636	**76**
NZ hedging gain/loss (incl mkt costs)	7	(1)	**-8**	79	33	**(46)**
NZ generation/wholesale performance	(21)	(7)	**13**	(130)	(69)	**60**
Estimated NZ Energy Margin	**76**	**96**	**19**	**510**	**600**	**90**
Aus retail contribution (A$m)	1	6	5	6	17	12
Aus hedging gain/loss (incl mkt costs) (A$m)	0	(2)	(2)	1	(2)	(3)
Aus generation/wholesale performance (A$m)	7	5	(2)	54	46	(8)
Estimated Aus Energy Margin (A$m)	**8**	**10**	**2**	**61**	**62**	**1**
Estimated Aus Energy Margin (NZ$m)	**8**	**10**	**2**	**66**	**66**	**0**
Operating costs	(22)	(22)	0	(135)	(144)	(9)
Est. transmission costs	(11)	(12)	(1)	(65)	(70)	(5)
Est. other revenue	2	3	0	13	15	2
Est MEL EBITDAF (NZ$m)	**54**	**75**	20	**389**	**466**	78

Source: MEL, Forsyth Barr analysis

Figure 2. Historic NZ Energy Margin



Source: MEL, Forsyth Barr analysis

Forecast changes

Figure 3. Summary forecast changes

	FY20 Old	FY20 New	% Chg	FY21 Old	FY21 New	% Chg	FY21 Old	FY21 New	% Chg
NZ Energy Margin	1,127	1,135	0.7%	1,034	1,047	1.3%	1,014	1,035	2.0%
Australia Energy Margin	113	118	3.7%	102	114	12.7%	100	113	13.7%
EBITDAF	**852**	**863**	**1.2%**	**778**	**808**	**3.8%**	**768**	**806**	**5.0%**
EBIT	543	553	1.9%	476	506	6.3%	471	510	8.1%
Pre-tax profit	448	459	2.4%	379	410	8.2%	371	412	10.9%
NPAT	**322**	**330**	**2.4%**	**273**	**295**	**8.2%**	**267**	**297**	**10.9%**
Dividend (cps)	21.5	21.5	0.1%	21.8	21.9	0.4%	20.6	21.2	3.1%
NZ Generation (GWh)	14,256	14,117	-1.0%	13,354	13,419	0.5%	13,175	13,175	0.0%
FPVV sales (GWh)	6,869	6,990	1.8%	6,997	7,124	1.8%	7,107	7,236	1.8%
Customer numbers (000)	315	317	0.5%	321	323	0.5%	328	330	0.5%
GWAP ($/MWh)	$99.8	$97.2	-2.6%	$99.4	$98.3	-1.1%	$83.7	$86.6	3.4%

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.

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.

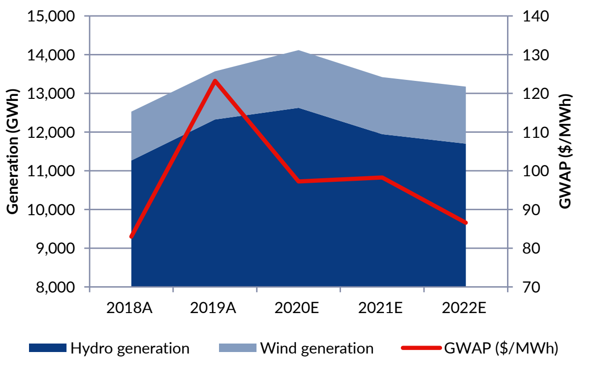
Key risks

- **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.

Company description

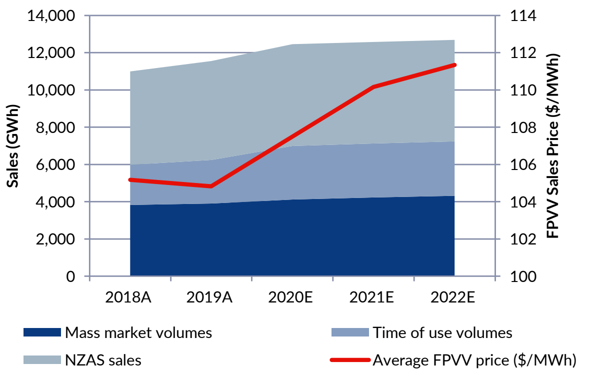
Meridian is New Zealand's largest electricity generator/retailer. It produces ~11,500GWh of electricity from its South Island hydro power stations and ~1,500GWh from its predominantly North Island wind farms. MEL's retail brands, Meridian and Powershop retail electricity to around 290,000 customers. 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.

Figure 4. Generation and average price received



Source: MEL, Forsyth Barr analysis

Figure 5. Retail sales volumes and average retail price



Source: MEL, Forsyth Barr analysis

Figure 6. Substantial Shareholders

Shareholder	Latest Holding
NZ Govt	51.0%

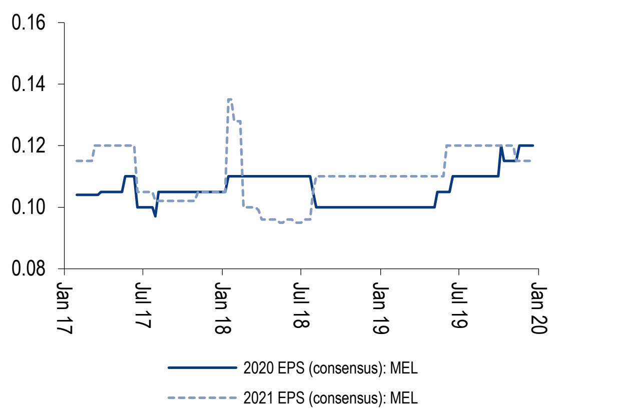
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 7. International Compcos

Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash D/Yld
(metrics re-weighted to reflect MEL's balance date - June)			(m)	2020E	2021E	2020E	2021E	2020E	2021E	2021E
Meridian Energy	**MEL NZ**	**NZ$5.16**	**NZ$13,225**	**25.8x**	**28.0x**	**17.0x**	**18.1x**	**26.5x**	**28.9x**	**4.2%**
Contact Energy *	CEN NZ	NZ$7.43	NZ$5,335	20.6x	19.9x	13.1x	12.7x	22.7x	21.4x	5.3%
Genesis Energy *	GNE NZ	NZ$3.17	NZ$3,263	20.9x	16.5x	12.2x	10.9x	28.8x	22.7x	5.6%
Mercury *	MCY NZ	NZ$5.20	NZ$7,084	28.4x	25.6x	15.8x	15.5x	26.0x	25.3x	3.1%
Trustpower *	TPW NZ	NZ$7.25	NZ$2,269	23.4x	21.8x	13.8x	13.3x	17.1x	16.5x	4.7%
AGL Energy	AGL AT	A$20.50	A$13,100	15.8x	15.8x	7.5x	7.5x	11.5x	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
Infigen Energy	IFN AT	A$0.69	A$659	15.2x	20.8x	7.2x	8.2x	11.7x	14.6x	2.9%
Origin Energy	ORG AT	A$8.63	A$15,199	14.4x	13.9x	6.5x	6.4x	15.8x	15.6x	4.4%
			Compco Average:	**19.8x**	**19.2x**	**10.9x**	**10.6x**	**19.1x**	**18.2x**	**4.4%**
EV = Current Market Cap + Actual Net Debt			**MEL Relative:**	**+30%**	**+46%**	**+56%**	**+70%**	**+39%**	**+59%**	**-4%**

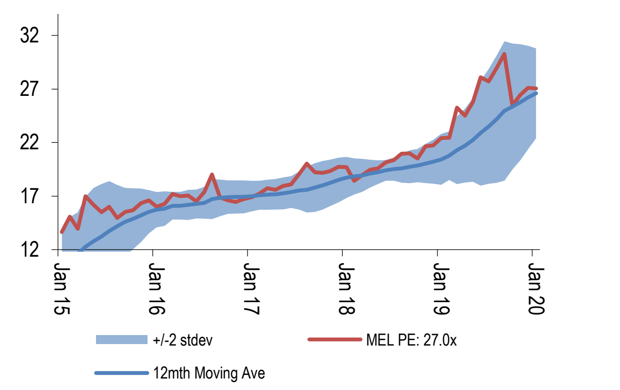
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (MEL) companies fiscal year end

Figure 8. Consensus EPS Momentum



Source: Forsyth Barr analysis, Bloomberg

Figure 9. 12 Month Forward PE



Source: Forsyth Barr analysis

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