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Meridian Energy
Breaking Records is Becoming a Broken Record — 1H20 Result Review

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NEUTRAL

It probably shouldn't come as any surprise that Meridian Energy (MEL) has once again reported record breaking 1H20 EBITDAF of $465m, +20% higher than the pcp and +4% higher than 2H19. It is MEL's third consecutive record six-monthly EBITDAF. However, overhanging MEL's commentary, and actions is NZAS uncertainty. MEL has kept its interim dividend flat for that reason despite the record result.

What's changed

- **EBITDAF forecasts:** FY20/FY21/FY22 +$1m/-$1m/+$2m to $864m/$807m/$808m
- **Target price and rating:** Unchanged at $4.40 and NEUTRAL respectively

NZX Code	MEL
Share price	NZ$5.09
Target price	NZ$4.40
Risk rating	Low
Issued shares	2563.0m
Market cap	NZ$13,046m
Avg daily turnover	1,537k (NZ$7,230k)

Financials: Jun/	19A	20E	21E	22E
NPAT* (NZ$m)	481.3	500.9	450.8	450.9
EPS* (NZc)	18.8	19.5	17.6	17.6
EPS growth* (%)	33.4	4.1	-10.0	0.0
DPS (NZc)	21.3	21.5	21.5	21.2
Imputation (%)	66	65	65	70

*Based on normalised profits

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	17.3	16.8	18.1	18.1
EV/EBIT	25.8	26.5	29.5	29.2
PE	27.1	26.0	28.9	28.9
Price / NTA	2.4	2.5	2.7	2.8
Cash div yld (%)	4.2	4.2	4.2	4.2
Gross div yld (%)	5.3	5.3	5.3	5.3

Breaking EBITDAF records is getting monotonous

The wholesale market conditions keep providing for MEL. Record 1H hydro and wind generation volumes, above average wholesale electricity prices (albeit below the pcp) and a free run at the commercial market have all contributed to NZ EBITDAF increasing +22% vs. the pcp to $426m. In contrast to New Zealand, Australia's EBITDAF contribution ($39m) was flat (-$2m) on the pcp, with drought conditions impacting generation volumes. The result contained no surprises.

Sufficient momentum to post an FY20 record, but don't expect the records to continue

We have left our forecasts largely unchanged. Our FY20 EBITDAF forecast of $864m is +3% higher than the pcp. To achieve that result requires MEL to report 2H20 EBITDAF of $399m, -$50m lower than 2H19. Whilst there are some challenges in 2H20, $864m is very achievable and would be the eighth consecutive year of FY EBITDAF growth — a remarkable achievement for a supposedly volatile business. Longer-term, we expect the wholesale electricity market to normalise, Contact Energy to re-enter the commercial market and a lower electricity price to NZAS. Partially offsetting those headwinds are reducing transmission costs and modest growth in Australia, such that our estimate of MEL's normalised hydrology EBITDAF is ~$800m. However, with MEL trading on an FY21 EBITDAF multiple ~+30% higher than its peers, we retain our NEUTRAL rating.

NZAS delays planned announcements around dividend and potentially Hawkes Bay wind

Overhanging everything MEL does at present is NZAS. Its interim dividend of 8.14cps (including 2.44cps capital management special dividend) is flat on the pcp despite record breaking earnings. In addition, MEL had originally intended to update the market on a revised dividend policy post-1H22 when the current capital management programme ends. That has been deferred. In addition, the final investment decision on its Harapaki wind project in Hawkes Bay will not be made until mid-2020.

Meridian Energy Limited (MEL)

Priced as at 26 Feb 2020 (NZ$)	**5.09**

12-month target price (NZ$)*	**4.40**
Expected share price return	-13.6%
Net dividend yield	4.2%
Estimated 12-month return	-9.3%

Spot valuations (NZ$)	
1. DCF	3.73
2. Market multiple	4.58
3. Dividend yield	4.61

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	11,156
(Net debt)/cash	(1,608)
Less: Capitalised operating leases	
Value of equity	9,548

Profit and Loss Account (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Sales revenue	3,297.0	4,104.0	3,435.8	3,593.2	3,501.3
Normalised EBITDA	**666.0**	**838.0**	**864.2**	**807.1**	**808.4**
Depreciation and amortisation	(21.0)	(276.0)	(314.4)	(310.7)	(306.1)
Normalised EBIT	**398.0**	**562.0**	**549.8**	**496.4**	**502.3**
Net interest	(81.0)	(83.0)	(83.7)	(80.8)	(80.0)
Associate income & other	(19.0)	(14.0)	(10.0)	(22.0)	(22.0)
Tax	(95.0)	(133.0)	(127.5)	(110.2)	(112.1)
Minority interests	0	0	0	0	0
Reported NPAT	**203.0**	**332.0**	**328.6**	**283.4**	**288.2**
Abnormals/other	157.8	149.3	172.3	167.4	162.6
Adjusted normalised NPAT	**360.8**	**481.3**	**500.9**	**450.8**	**450.9**
Normalised EPS (cps)	14.1	18.8	19.5	17.6	17.6
DPS (cps)	19.2	21.3	21.5	21.5	21.2

Valuation Ratios	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EV/EBITDA (x)	21.6	17.3	16.8	18.1	18.1
EV/EBIT (x)	36.1	25.8	26.5	29.5	29.2
PE (x)	36.2	27.1	26.0	28.9	28.9
Price/NTA (x)	2.7	2.4	2.5	2.7	2.8
Free cash flow yield (%)	1.4	4.3	3.5	3.9	3.9
Net dividend yield (%)	3.8	4.2	4.2	4.2	4.2
Gross dividend yield (%)	4.8	5.3	5.3	5.3	5.3

Capital Structure	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Interest cover EBIT (x)	4.7	6.6	6.5	5.9	6.0
Interest cover EBITDA (x)	8.2	10.1	10.3	10.0	10.1
Net debt/ND+E (%)	71.3	76.9	88.3	103.6	124.2
Net debt/EBITDA (x)	2.2	1.7	1.8	2.0	2.1

Growth Rates	**2018A**	**2019A**	**2020A**	**2021A**	**2022A**
Revenue (%)	16.7	24.5	-16.3	4.6	-2.6
EBITDA (%)	1.4	25.8	3.1	-6.6	0.2
EBIT (%)	1.3	41.2	-2.2	-9.7	1.2
Normalised NPAT (%)	-3.1	33.4	4.1	-10.0	0.0
Normalised EPS (%)	-3.1	33.4	4.1	-10.0	0.0
Ordinary DPS (%)	1.5	10.9	0.9	0.0	-1.4

Key Ratios	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Return on assets (%)	4.4	5.7	5.7	5.2	5.4
Return on equity (%)	4.3	6.1	6.0	5.4	5.8
Return on funds employed (%)	4.6	5.9	5.8	5.4	5.7
EBITDA margin (%)	20.2	20.4	25.2	22.5	23.1
EBIT margin (%)	12.1	13.7	16.0	13.8	14.3
Capex to sales (%)	7.5	1.7	2.1	2.1	1.7
Capex to depreciation (%)	n/a	28	25	27	21
Imputation (%)	68	66	65	65	70
Pay-out ratio (%)	136	113	110	122	121

Cash Flow (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EBITDA	**666.0**	**838.0**	**864.2**	**807.1**	**808.4**
Working capital change	(34.0)	(36.0)	(61.5)	31.1	17.0
Interest & tax paid	(186.0)	(200.0)	(280.4)	(234.7)	(237.1)
Other	(19.0)	33.0	3.0	(22.0)	(22.0)
Operating cash flow	**427.0**	**635.0**	**525.3**	**581.4**	**566.3**
Capital expenditure	(247.0)	(69.0)	(73.1)	(76.2)	(58.3)
(Acquisitions)/divestments	23.0	0	0	0	0
Other	0	0	0	0	0
Funding available/(required)	**203.0**	**566.0**	**452.2**	**505.2**	**508.0**
Dividends paid	(486.0)	(500.0)	(545.6)	(551.0)	(561.8)
Equity raised/(returned)	(2.0)	(2.0)	0	0	0
(Increase)/decrease in net debt	**(285.0)**	**64.0**	**(93.4)**	**(45.7)**	**(53.8)**

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 ($/MWh)	83	123	90	96	87
Overseas generation (GWh)	581	730	667	785	809
Overseas GWAP ($/MWh) (NZD)	151	96	113	100	91
Overseas customer numbers (000)	97	110	137	156	167
NZ electricity customers (000)	**291**	**302**	**320**	**331**	**338**
Average usage per cust (MWh/yr)	13.5	13.2	13.6	13.5	13.5
Mass market volumes	3,824	3,901	4,240	4,404	4,525
Time of use volumes	2,157	2,338	3,003	2,938	2,791
Total fixed price volumes (GWh)	**5,981**	**6,239**	**7,242**	**7,342**	**7,316**
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**	**12,475**	**12,807**	**12,781**
Average FPVV price ($/MWh)	105	105	108	110	112
LWAP ($/MWh)	88	132	97	103	93
LWAP/GWAP	1.06	1.07	1.07	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	(17.0)	(24.0)	3.5	(5.6)	(0.6)
Fixed assets	7,941.0	8,825.0	8,659.2	8,425.6	8,176.1
Intangibles	60.0	59.0	56.5	55.7	57.3
Right of use asset	0	0	0	0	0
Other assets	291.0	383.0	403.0	381.0	359.0
Total funds employed	**8,275.0**	**9,243.0**	**9,122.2**	**8,856.6**	**8,591.7**
Net debt/(cash)	1,461.0	1,424.0	1,596.4	1,642.2	1,695.9
Lease liability	0	0	0	0	0
Other liabilities	1,991.0	2,362.0	2,284.8	2,241.0	2,195.9
Shareholder's funds	4,823.0	5,457.0	5,241.0	4,973.4	4,699.9
Minority interests	0	0	0	0	0
Total funding sources	**8,275.0**	**9,243.0**	**9,122.2**	**8,856.6**	**8,591.7**

1H20 result summary & forecast changes

Figure 1. 1H20 result summary

6 months ending 31 Dec	1H19 $m	1H20 $m	% Chg	FB $m	Diff $m	Comments
NZ Energy Margin	510	598	17%	599	(1)	Strong result due to record generation, high w/sale prices, & higher sales volumes at better prices
Australia Energy Margin	66	65	-2%	67	(2)	Flat Australia result, with better retail performance offset by weaker generation volumes
Energy margin	**576**	**663**	**15%**	**666**	**(3)**	
Other revenue	13	13	0%	15	(2)	Includes $5m ($6m in 1H19) of UK Flux revenue
Transmission costs	(65)	(68)	5%	(70)	2	Includes $5m payment to Transpower to start lower South Island transmission work
Operating costs	(135)	(143)	6%	(145)	2	Lift in opex previously signalled, but MEL is at risk of being an electricity outlier on opex
EBITDAF	**389**	**465**	**20%**	**466**	**(1)**	
Depn & amort	(137)	(157)	15%	(156)	(1)	Lift in depreciation due to FY19 asset revaluations
EBIT	**252**	**308**	**22%**	**310**	**(2)**	
Net interest	(43)	(43)	0%	(38)	(5)	Includes $3m of IFRS 16 lease interest costs
FV mvmts	5	-		(7)	7	
Pre-tax profit	**214**	**265**	**24%**	**266**	**(1)**	
Tax	(62)	(74)	19%	(74)	0	
NPAT	**152**	**191**	**26%**	**191**	**0**	
Normalised NPAT	**144**	**184**	**28%**	**186**	**(2)**	Normalisation adjustment is MEL swaption fees not captured in P&L
EPS (cps)	5.6	7.2	28%	7.5	(0.3)	
Dividend (cps)	8.14	8.14	0%	8.3	(0.20)	Flat dividend a modest surprise given earnings but due to NZAS decision overhang
Operating statistics						
Generation (GWh)	6,547	7,186	10%			Record generation volume levels
FPVV sales (GWh)	2,999	3,661	22%			Big lift in sales volumes, mainly to commercial customers
Customer numbers (000)	297	314	6%			MEL has also been very active in the mass market retail segment
GWAP ($/MWh)	124.0	101.2	-18%			Big drop in wholesale electricity prices, but still well above average/normal
Summary cashflow						
Operating cash flow	385	431	12%			Modest increase with working capital movement negative this year
Interest paid	(41)	(41)	0%			
Tax paid	(82)	(124)	51%			Timing of tax payments weighted to 1H in FY20
Maintenance capex	(23)	(24)	4%			Capex in line with guidance
Free cash flow	**239**	**242**	**1%**			Cash flow heavily weighted to 2H20

Source: MEL, Forsyth Barr analysis

Figure 2. Summary forecast changes

	FY20 Old	FY20 New	% Chg	FY21 Old	FY21 New	% Chg	FY21 Old	FY21 New	% Chg
NZ Energy Margin	1,135	1,139	0.4%	1,047	1,052	0.5%	1,035	1,041	0.6%
Australia Energy Margin	118	111	-5.6%	114	110	-3.8%	113	113	-0.1%
EBITDAF	**863**	**864**	**0.2%**	**808**	**807**	**-0.1%**	**806**	**808**	**0.3%**
EBIT	553	550	-0.7%	506	496	-1.9%	510	502	-1.4%
Pre-tax profit	459	456	-0.6%	410	393	-3.9%	412	400	-2.9%
NPAT	330	329	-0.5%	295	283	-3.9%	297	288	-2.9%
Normalised NPAT	**330**	**314**	**-4.9%**	**295**	**267**	**-9.3%**	**297**	**272**	**-8.2%**
Dividend (cps)	21.5	21.5	0.0%	21.9	21.5	-1.9%	21.2	21.2	-2.4%

Source: Forsyth Barr analysis

NZAS 2019 result — RIO appears to be playing accounting games

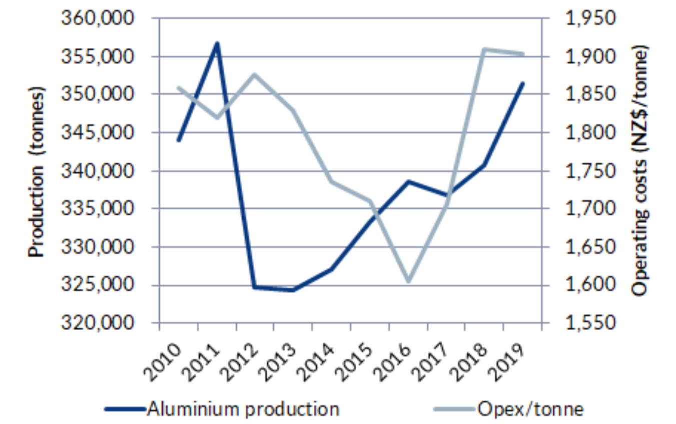
In a case of convenient timing, earlier this week NZAS released its FY19 result (usually this is released in May/June) and Rio Tinto (RIO) has overnight also released its FY19 result.

Pacific Aluminium (NZ) Limited (PacAl NZ) reported an underlying NPAT loss for 2019 of -$46m (EBITDA of -NZ$49m) vs 2018 NPAT of NZ$22m (EBITDAF of $36m). Within the RIO result, it reported that the Pacific Aluminium group (of which NZAS is part) EBITDA result was a loss of -US$22m (vs. US$148m in 2018). The headline results are curious in that we struggle to reconcile them with underlying market conditions, whereas we've able to do so for previous results.

- The average LME aluminium price / alumina spread was effectively the same across 2019 and 2018. NZ$2,049/tonne in 2019 vs. $2,073/tonne in 2018, a decline of -1%.
- RIO has reported that the value added premium was +19% across its portfolio, up from +17% in 2018.
- NZAS sold 353k tonnes of aluminium, +4% more than the pcp, so should have achieved economies of scale (although that does not appear to be the case). NZAS opex/tonne was elevated in 2019 despite the higher production (we suspect 2018 opex was elevated due to pot line 4 being recommissioned in October 2018).

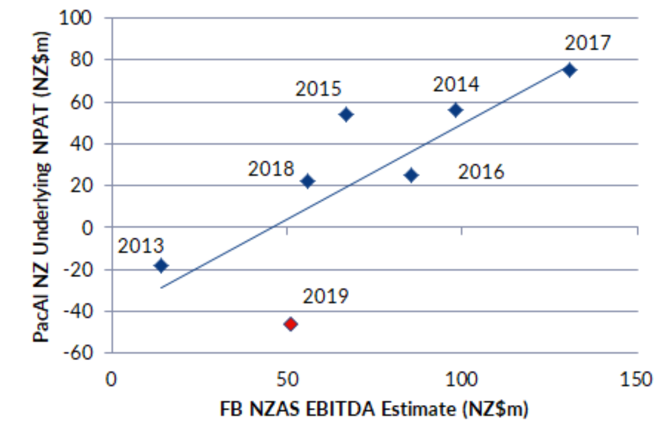
Our analysis suggests NZAS made EBITDA of ~NZ$51m in 2019, just -$5m lower than the pcp. As highlighted below, the PacAl NZ loss of NZ$46m appears an outlier compared to previous years. Simple regression analysis (excl 2019) suggests the PacAl NZ NPAT result should have been ~NZ$18m.

Figure 3. Aluminium production and operating costs



Source: NZAS, Forsyth Barr analysis

Figure 4. FB EBITDA estimate vs. PacAl NZ NPAT



Source: NZAS, Forsyth Barr analysis

Other points to note from the NZAS financial statements and RIO result presentation that support our view NZAS will remain open:

- Our estimate of the future value of the rehabilitation provision has increased ~+NZ$20 to ~NZ$360m.
- NZAS continues to assume the going concern assumption (although it noted the strategic review) and has not impaired the asset value. NZAS auditors signed off on these assumptions, implicitly accepting the asset carrying value of NZ$445m.
- RIO's result presentation spent significant time focussing on climate change and its efforts to reduce its carbon footprint — in our view this is inconsistent with closing one of the low emission aluminium smelters.

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 cashflow 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.

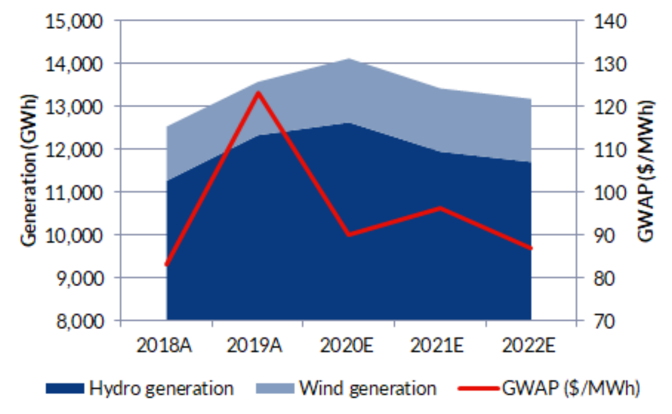
Financial structure

- **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.

Risk factors

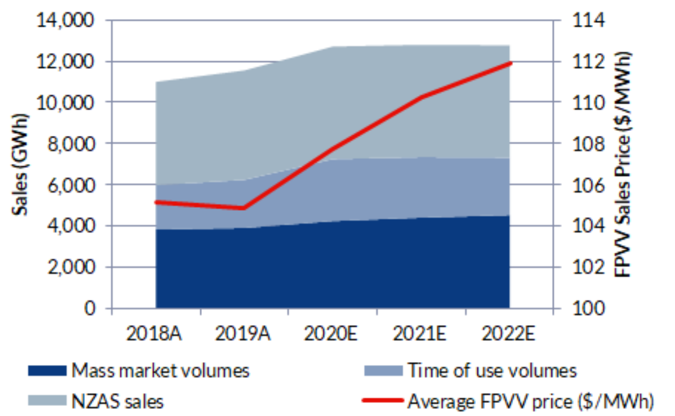
- **Political/regulatory:** The 2014 election and recent Electricity Price Review (EPR) highlighted the political/regulatory risks inherent in the sector. Whilst the EPR gave the sector a thumbs up in most areas, the political risk is unlikely to ever disappear.
- **NZAS risk:** NZAS has indicated it is undertaking a strategic review, raising the possibility it may close. In our view, the smelter is unlikely to close (less than 10% chance).

Figure 5. Generation and average price received



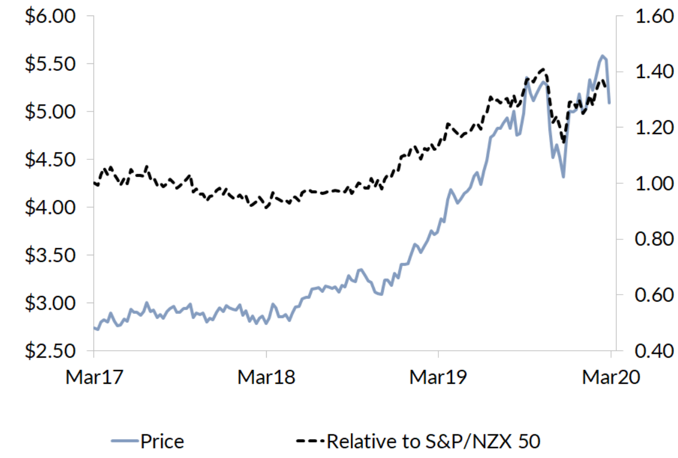
Source: MEL, Forsyth Barr analysis

Figure 6. Retail sales volumes and average retail price



Source: MEL, Forsyth Barr analysis

Figure 7. Price performance



Source: Forsyth Barr analysis

Figure 8. Substantial shareholders

Shareholder	Latest Holding
NZ Govt	51.0%

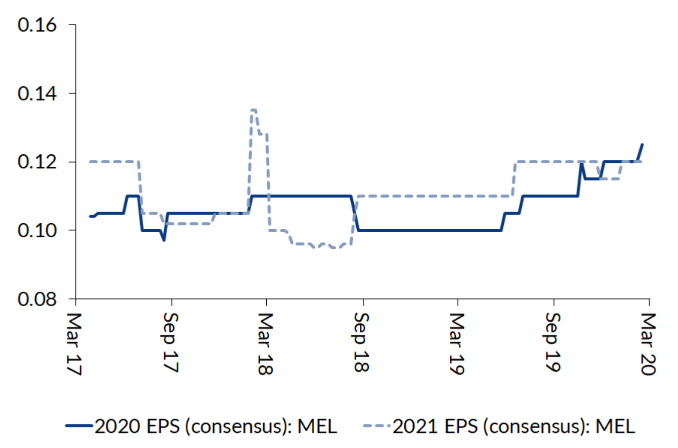
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 9. International valuation comparisons

Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash Yld
(metrics re-weighted to reflect MEL's balance date - June)			(m)	2020E	2021E	2020E	2021E	2020E	2021E	2021E
Meridian Energy	**MEL NZ**	**NZ$5.09**	**NZ$13,046**	**26.0x**	**28.9x**	**16.7x**	**17.9x**	**26.3x**	**29.2x**	**4.2%**
Contact Energy *	CEN NZ	NZ$7.20	NZ$5,170	22.2x	20.7x	13.8x	12.9x	27.0x	24.9x	5.4%
Genesis Energy *	GNE NZ	NZ$3.17	NZ$3,258	20.0x	16.7x	12.3x	11.1x	32.2x	26.5x	5.5%
Mercury *	MCY NZ	NZ$5.36	NZ$7,302	31.0x	26.8x	16.8x	16.0x	28.3x	26.5x	3.0%
Trustpower *	TPW NZ	NZ$6.94	NZ$2,172	22.4x	20.9x	13.3x	12.9x	16.5x	15.9x	4.9%
AGL ENERGY	AGL AT	A$20.48	A$13,087	15.5x	15.5x	7.6x	7.5x	11.7x	11.6x	4.9%
INFIGEN ENERGY	IFN AT	A$0.70	A$674	15.6x	17.9x	7.0x	7.6x	11.2x	13.1x	2.9%
ORIGIN ENERGY	ORG AT	A$7.31	A$12,874	12.5x	12.9x	6.0x	6.1x	14.3x	15.1x	4.9%
			Compco Average:	**19.9x**	**18.8x**	**11.0x**	**10.6x**	**20.2x**	**19.1x**	**4.5%**
EV = Current Market Cap + Actual Net Debt			**MEL Relative:**	**31%**	**54%**	**53%**	**69%**	**30%**	**53%**	**-6%**

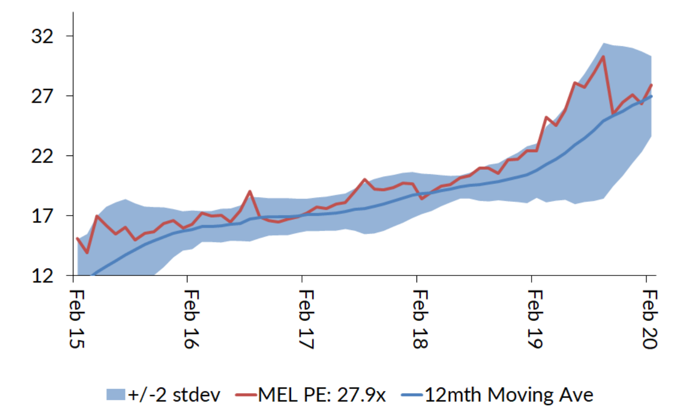
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (MEL) companies fiscal year end

Figure 10. Consensus EPS momentum (NZ$)



Source: Forsyth Barr analysis

Figure 11. One year forward PE (x)



Source: Forsyth Barr analysis

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