

Meridian Energy

Earnings Take Rare Haircut

ANDREW HARVEY-GREEN

andrew.harvey-green@forsythbarr.co.nz
+64 4 495 8185

SCOTT ANDERSON

scott.anderson@forsythbarr.co.nz
+64 4 914 2219

OUTPERFORM

We are used to upgrading Meridian Energy's (MEL) earnings forecast, so the modest -NZ\$9m (-1.1%) cut to our FY20 EBITDAF estimate is unusual. That said, our revised EBITDAF forecast of NZ\$861m is still a record, so it's hardly bad news. We have also trimmed our dividend forecast -0.2cps to 19.1cps. OUTPERFORM remains the rating, as we continue to like MEL's long-term prospects, albeit there is a degree of uncertainty in the near-term due to the expected closure of NZAS.

NZX Code	MEL	Financials: Jun/	19A	20E	21E	22E	Valuation (x)	19A	20E	21E	22E
Share price	NZ\$4.75	NPAT* (NZ\$m)	481.3	498.7	444.8	374.4	EV/EBITDA	16.2	15.9	17.3	21.0
Target price	NZ\$4.80	EPS* (NZc)	18.8	19.5	17.4	14.6	EV/EBIT	24.2	25.0	28.3	39.5
Risk rating	Low	EPS growth* (%)	33.4	3.6	-10.8	-15.8	PE	25.3	24.4	27.4	32.5
Issued shares	2563.0m	DPS (NZc)	21.3	19.1	16.7	16.7	Price / NTA	2.3	2.3	2.4	2.5
Market cap	NZ\$12,174m	Imputation (%)	66	70	75	65	Cash div yld (%)	4.5	4.0	3.5	3.5
Avg daily turnover	1,719k (NZ\$8,231k)	*Based on normalised profits					Gross div yld (%)	5.6	5.1	4.5	4.4

June 2020 operating statistics point to a weak finish

We estimate that June EBITDAF was NZ\$55m, -NZ\$27m lower than the pc. Several factors impacted on the June performance:

- Lower generation volumes (down -12% vs. pc) and increased use of the swaption which is a higher cost than most CFDs
- NZ\$5m provision related to the draft undesirable trading situation (UTS) decision
- Higher than normal line losses due to wash-ups

We have lowered our FY20 EBITDAF forecast -NZ\$9m to NZ\$861m, which is still +NZ\$23m (+2.8%) higher than the record FY19 result.

Dividend forecast also trimmed as we expect MEL to apply the bottom of its dividend policy range

Our revised FY20 final dividend of 11.0cps (FY20 dividend of 19.2cps), is down -0.2cps due to the expected lower FY20 EBITDAF result. Our forecast assumes MEL pays out 75% of its FY20 free cash flow, the bottom end of its dividend policy payout ratio range. We expect MEL will be able to maintain this dividend level going forward as it uses its balance sheet to shelter investors through the upcoming difficult earnings years.

MEL and sector in holding pattern as they await final NZAS closure timing decision

MEL has tabled offers to defer the closure of NZAS, with several options in front of Rio Tinto (RIO). Whilst there are logical reasons for RIO to defer closure of NZAS (we expect the offers are reasonably generous given the downside effects of closure, plus the benefit of deferring closure costs), in our view there were strong reasons why NZAS should have remained open and hence our base position remains that NZAS closes on 31 August 2021 - anything later would be a bonus.

Meridian Energy Limited (MEL)

Priced as at 27 Jul 2020 (NZ\$) **4.75**

12-month target price (NZ\$)*	4.80
Expected share price return	1.1%
Net dividend yield	3.5%
Estimated 12-month return	4.6%

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

Spot valuations (NZ\$)	
1. DCF	3.54
2. Market multiple	5.25
3. Dividend yield	5.39

DCF valuation summary (NZ\$m)	
Total firm value	10,895
(Net debt)/cash	(1,817)
Less: Capitalised operating leases	
Value of equity	9,078

Profit and Loss Account (NZ\$m)	2018A	2019A	2020E	2021E	2022E
Sales revenue	3,297.0	4,104.0	3,544.1	3,528.9	3,001.1
Normalised EBITDA	666.0	838.0	861.1	797.5	655.4
Depreciation and amortisation	(21.0)	(276.0)	(314.4)	(310.7)	(306.7)
Normalised EBIT	398.0	562.0	546.8	486.7	348.6
Net interest	(81.0)	(83.0)	(83.7)	(79.5)	(77.1)
Associate income & other	(19.0)	(14.0)	(10.0)	(22.0)	0
Tax	(95.0)	(133.0)	(126.7)	(107.9)	(76.0)
Minority interests	0	0	0	0	0
Reported NPAT	203.0	332.0	326.4	277.4	195.5
Abnormals/other	157.8	149.3	172.3	167.4	178.9
Adjusted normalised NPAT	360.8	481.3	498.7	444.8	374.4
Normalised EPS (cps)	14.1	18.8	19.5	17.4	14.6
DPS (cps)	19.2	21.3	19.1	16.7	16.7

Valuation Ratios	2018A	2019A	2020E	2021E	2022E
EV/EBITDA (x)	20.2	16.2	15.9	17.3	21.0
EV/EBIT (x)	33.9	24.2	25.0	28.3	39.5
PE (x)	33.7	25.3	24.4	27.4	32.5
Price/NTA (x)	2.6	2.3	2.3	2.4	2.5
Free cash flow yield (%)	1.5	4.6	3.7	4.0	2.8
Net dividend yield (%)	4.0	4.5	4.0	3.5	3.5
Gross dividend yield (%)	5.1	5.6	5.1	4.5	4.4

Capital Structure	2018A	2019A	2020E	2021E	2022E
Interest cover EBIT (x)	4.7	6.6	6.4	5.8	4.5
Interest cover EBITDA (x)	8.2	10.1	10.3	10.0	8.5
Net debt/ND+E (%)	71.3	76.9	88.4	96.3	112.1
Net debt/EBITDA (x)	2.2	1.7	1.8	1.9	2.5

Growth Rates	2018A	2019A	2020A	2021A	2022A
Revenue (%)	16.7	24.5	-13.6	-0.4	-15.0
EBITDA (%)	1.4	25.8	2.8	-7.4	-17.8
EBIT (%)	1.3	41.2	-2.7	-11.0	-28.4
Normalised NPAT (%)	-3.1	33.4	3.6	-10.8	-15.8
Normalised EPS (%)	-3.1	33.4	3.6	-10.8	-15.8
Ordinary DPS (%)	1.5	10.9	-10.2	-12.8	0.0

Key Ratios	2018A	2019A	2020E	2021E	2022E
Return on assets (%)	4.4	5.7	5.7	5.1	3.9
Return on equity (%)	4.3	6.1	6.0	5.1	4.0
Return on funds employed (%)	4.6	5.9	5.8	5.3	3.9
EBITDA margin (%)	20.2	20.4	24.3	22.6	21.8
EBIT margin (%)	12.1	13.7	15.4	13.8	11.6
Capex to sales (%)	7.5	1.7	2.1	2.2	4.3
Capex to depreciation (%)	n/a	28	25	27	45
Imputation (%)	68	66	70	75	65
Pay-out ratio (%)	136	113	98	96	114

Cash Flow (NZ\$m)	2018A	2019A	2020E	2021E	2022E
EBITDA	666.0	838.0	861.1	797.5	655.4
Working capital change	(34.0)	(36.0)	(54.9)	22.0	11.6
Interest & tax paid	(186.0)	(200.0)	(279.6)	(231.1)	(197.9)
Other	(19.0)	33.0	3.0	(22.0)	0
Operating cash flow	427.0	635.0	529.6	566.3	469.1
Capital expenditure	(247.0)	(69.0)	(73.1)	(76.2)	(128.3)
(Acquisitions)/divestments	23.0	0	0	0	0
Other	0	0	0	0	0
Funding available/(required)	203.0	566.0	456.5	490.1	340.8
Dividends paid	(486.0)	(500.0)	(545.6)	(427.9)	(427.9)
Equity raised/(returned)	(2.0)	(2.0)	0	0	0
(Increase)/decrease in net debt	(285.0)	64.0	(89.1)	62.2	(87.0)

Operating Performance	2018A	2019A	2020E	2021E	2022E
Hydro generation	11,266	12,326	12,753	12,353	10,600
Wind generation	1,263	1,244	1,471	1,430	1,430
Total NZ generation (GWh)	12,528	13,570	14,224	13,783	12,030
GWAP (\$/MWh)	83	123	91	81	54
Overseas generation (GWh)	581	730	642	713	810
Overseas GWAP (\$/MWh) (NZD)	151	96	119	92	77
Overseas customer numbers (000)	97	110	136	153	164

Balance Sheet (NZ\$m)	2018A	2019A	2020E	2021E	2022E
Working capital	(17.0)	(24.0)	(3.1)	(3.1)	(14.7)
Fixed assets	7,941.0	8,825.0	8,659.2	8,425.6	8,245.5
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	381.0
Total funds employed	8,275.0	9,243.0	9,115.7	8,859.2	8,669.1
Net debt/(cash)	1,461.0	1,424.0	1,592.1	1,529.8	1,616.9
Lease liability	0	0	0	0	0
Other liabilities	1,991.0	2,362.0	2,284.8	2,241.0	2,196.3
Shareholder's funds	4,823.0	5,457.0	5,238.8	5,088.3	4,856.0
Minority interests	0	0	0	0	0
Total funding sources	8,275.0	9,243.0	9,115.7	8,859.2	8,669.1

NZ electricity customers (000)	291	302	324	349	380
Average usage per cust (MWh/yr)	13.5	13.2	13.9	13.8	13.8
Mass market volumes	3,824	3,901	4,342	4,657	5,023
Time of use volumes	2,157	2,338	3,034	3,594	4,205
Total fixed price volumes (GWh)	5,981	6,239	7,376	8,251	9,228
NZAS sales	5,011	5,310	5,359	5,011	842
Sell CFDs	2,278	2,239	2,529	1,902	2,902
Buy CFDs	(2,222)	(1,965)	(2,731)	(1,995)	(1,496)
Total Sales (GWh)	11,047	11,823	12,533	13,169	11,476
Average FPV price (\$/MWh)	105	105	108	105	98
LWAP (\$/MWh)	88	132	96	90	64
LWAP/GWAP	1.06	1.07	1.05	1.10	1.19
Lines losses (%)	5.3	5.9	5.7	5.5	5.5

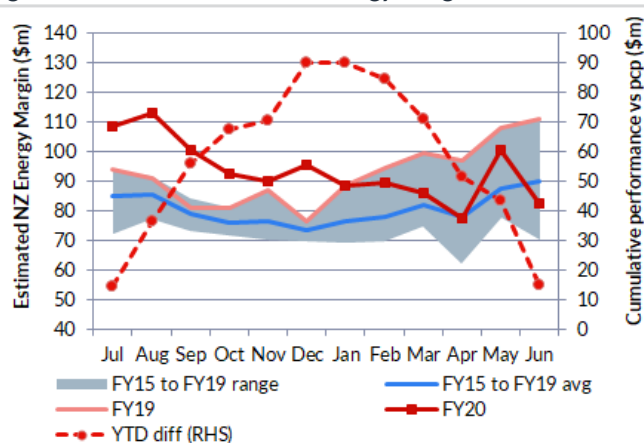
June 2020 operating performance

Figure 1. Estimated EBITDAF breakdown

	Jun-19 \$m	Jun-20 \$m	Diff \$m	YTD Jun-19 \$m	YTD Jun-20 \$m	Diff \$m
NZ retail revenue	103	121	18	1,178	1,325	146
NZ hedging gain/loss (incl mkt costs)	5	12	7	132	14	-118
NZ generation/wholesale performance	3	-50	-53	-202	-216	-14
Estimated NZ Energy Margin	111	82	-29	1,108	1,123	15
AU retail contribution (A\$m)	1	6	5	5	40	35
AU hedging gain/loss (incl mkt costs) (A\$m)	0	-1	-1	2	-8	-10
AU generation/wholesale performance (A\$m)	7	3	-5	106	85	-21
Estimated AU Energy Margin (A\$m)	9	8	-1	113	117	4
Estimated AU Energy Margin (NZ\$m)	9	8	-1	118	123	5
Operating costs	-29	-28	1	-282	-288	-6
Est. transmission costs	-11	-9	2	-131	-123	8
Est. other revenue	2	2	0	25	26	1
Est MEL EBITDAF (NZ\$m)	82	55	-27	838	861	23

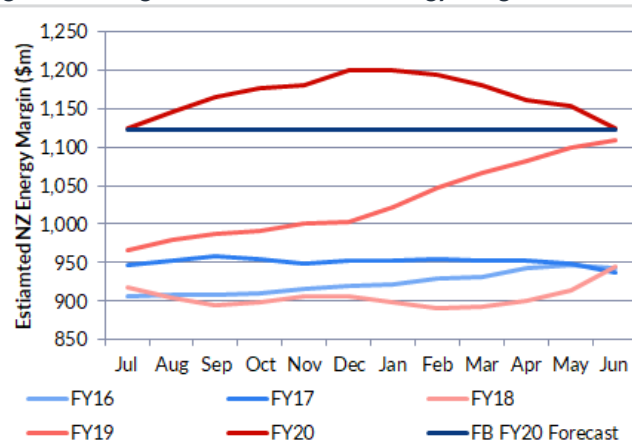
Source: MEL, Forsyth Barr analysis

Figure 2. Historic estimated NZ Energy Margin



Source: Forsyth Barr analysis

Figure 3. Rolling 12-month estimated Energy Margin



Source: Forsyth Barr analysis

Summary forecast changes

Figure 4. Summary forecast changes

NZ\$m	FY20 Old	FY20 New	% Chg	FY21 Old	FY21 New	% Chg	FY21 Old	FY21 New	% Chg
NZ Energy Margin	1,140	1,123	-1.5%	1,056	1,055	-0.1%	904	895	-1.0%
Australia Energy Margin	117	123	5.0%	107	110	3.1%	111	116	4.6%
EBITDAF	870	861	-1.1%	792	797	0.7%	657	655	-0.2%
EBIT	556	547	-1.7%	481	487	1.1%	350	349	-0.4%
Pre-tax profit	462	453	-2.0%	380	385	1.4%	273	272	-0.5%
NPAT	333	326	-2.0%	274	277	1.4%	197	196	-0.5%
Normalised NPAT	319	312	-2.1%	258	262	1.4%	197	196	-0.5%
FY dividend (cps)	19.4	19.1	-1.1%	16.9	16.7	-1.3%	16.9	16.7	-1.3%

Source: Forsyth Barr analysis

Investment Summary

Our rating is **OUTPERFORM**. MEL has been the strongest electricity performer in recent years and its low cost generation assets provides it with a strong defensive position. We believe MEL is in a strong position to grow retail market share in coming years which will help it rebound from a couple of difficult years after NZAS has closed.

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 underlying operating earnings ~+33%.

Earnings and cashflow outlook

- **Earnings to fall following NZAS closure, then rebound:** We expect earnings to fall in FY22 and FY23 as MEL is unable to export all of its electricity from the lower South Island after NZAS closes. However, we expect a quick rebound, aided by retail market share growth, backed by its low cost generation.

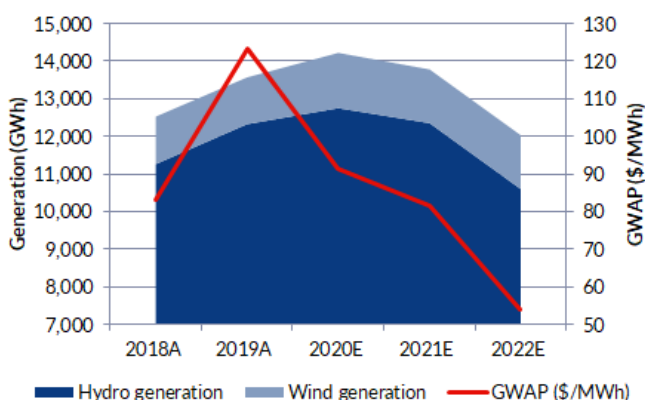
Financial structure

- **Balance sheet:** Management recognises that surplus cash is better with shareholders. However, its capital management plan is on hold for the foreseeable future due to the closure of NZAS.
- **Dividends:** Whilst MEL's special dividend has ended, we do not foresee a cut to the ordinary dividend. We expect dividend growth to resume when earnings growth recommences.

Risk factors

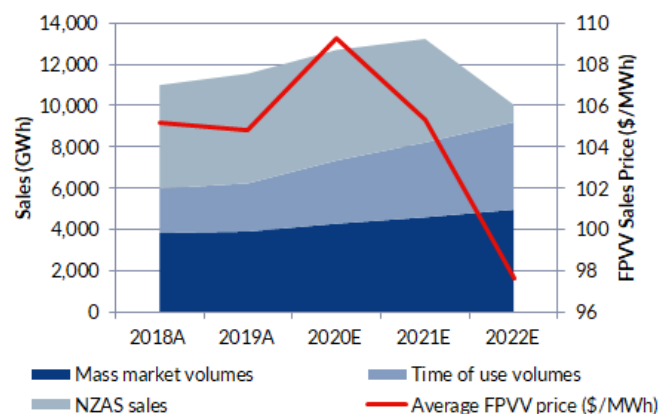
- **Political/regulatory:** The 2014 election and recent Electricity Price Review (EPR) highlighted the political/regulatory risks inherent in the sector. Whilst the EPR gave the sector a thumbs up in most areas, the political risk is unlikely to ever disappear.
- **NZAS closure:** Rio Tinto (RIO) has announced it intends to shutter the Tiwai Point aluminium smelter NZAS in August 2021. There are many sector uncertainties, although we believe the downside risks are fully factored into the share price.

Figure 5. Generation and average price received

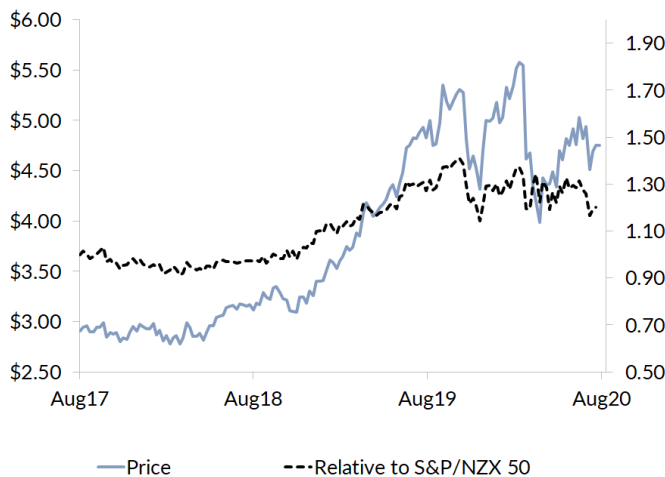


Source: MEL, Forsyth Barr analysis

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%

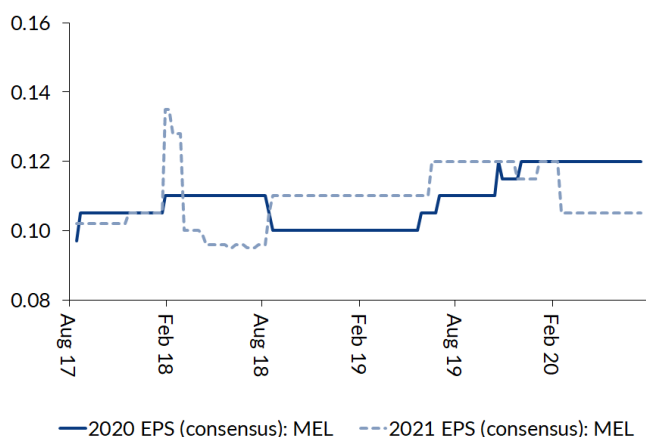
Source: NZX, Forsyth Barr analysis, NOTE: based on SPH notices only

Figure 9. International valuation comparisons

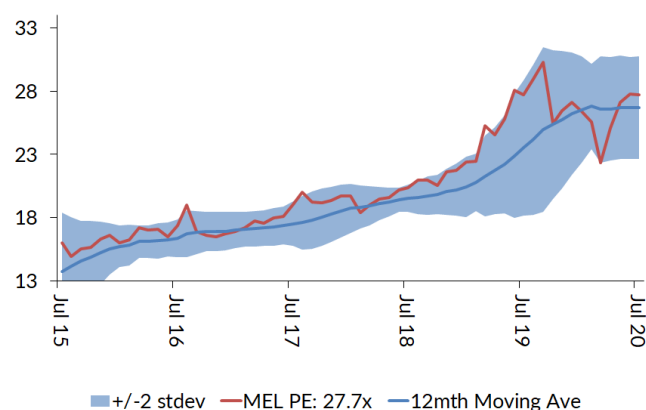
Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash Yld
(metrics re-weighted to reflect MEL's balance date - June)										
			(m)	2020E	2021E	2020E	2021E	2020E	2021E	2021E
Meridian Energy	MEL NZ	NZ\$4.75	NZ\$12,174	24.4x	27.4x	15.8x	17.1x	24.9x	27.9x	3.5%
CONTACT ENERGY *	CEN NZ	NZ\$5.86	NZ\$4,208	17.6x	18.0x	11.4x	11.5x	21.9x	23.1x	5.5%
GENESIS ENERGY *	GNE NZ	NZ\$2.93	NZ\$3,040	19.7x	17.1x	12.2x	11.4x	33.8x	28.4x	4.8%
MERCURY *	MCY NZ	NZ\$4.69	NZ\$6,389	28.3x	25.4x	15.5x	15.0x	26.5x	26.1x	3.4%
TRUSTPOWER *	TPW NZ	NZ\$6.82	NZ\$2,134	27.8x	24.3x	14.7x	14.5x	19.2x	19.2x	4.4%
AGL ENERGY	AGL AT	A\$17.23	A\$10,737	13.4x	13.7x	6.5x	6.7x	10.2x	10.7x	5.4%
INFIGEN ENERGY	IFN AT	A\$0.92	A\$893	25.6x	31.7x	8.8x	9.9x	14.8x	18.3x	2.2%
ORIGIN ENERGY	ORG AT	A\$5.71	A\$10,057	10.1x	19.0x	5.2x	6.4x	12.6x	20.4x	3.6%
Compco Average:				20.4x	21.3x	10.6x	10.8x	19.8x	20.9x	4.2%
MEL Relative:				20%	28%	49%	59%	25%	34%	-16%
EV = Current Market Cap + Actual Net Debt										

EV = Current Market Cap + Actual Net Debt

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

Analyst certification: The research analyst(s) primarily responsible for the preparation and content of this publication ("**Analysts**") are named on the first page of this publication. Each such Analyst certifies (other than in relation to content or views expressly attributed to another analyst) that (i) the views expressed in this publication accurately reflect their personal views about each issuer and financial product referenced and were prepared in an independent manner, including with respect to Forsyth Barr Limited and its related companies; and (ii) no part of the Analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by that Analyst in this report.

Analyst holdings: The following Analyst(s) have a threshold interest in the financial products referred to in this publication: Andrew Harvey-Green. For these purposes, a threshold interest is defined as being a holder of more than \$50,000 in value or 1% of the financial products on issue, whichever is the lesser.

Ratings distributions: As at 24 Jul 2020, Forsyth Barr's research ratings were distributed as follows:

OUTPERFORM	NEUTRAL	UNDERPERFORM
44.2%	42.3%	13.5%

Forsyth Barr's research ratings are OUTPERFORM, NEUTRAL, and UNDERPERFORM. The ratings are relative to our other equity security recommendations across our New Zealand market coverage and are based on risk-adjusted Estimated Total Returns for the securities in question. Risk-adjusted Estimated Total Returns are calculated from our assessment of the risk profile, expected dividends and target price for the relevant security.

Disclosure: Forsyth Barr Limited and its related companies (and their respective directors, officers, agents and employees) ("Forsyth Barr") may have long or short positions or otherwise have interests in the financial products referred to in this publication, and may be directors or officers of, and/or provide (or be intending to provide) investment banking or other services to, the issuer of those financial products (and may receive fees for so acting). Forsyth Barr is not a registered bank within the meaning of the Reserve Bank of New Zealand Act 1989. Forsyth Barr may buy or sell financial products as principal or agent, and in doing so may undertake transactions that are not consistent with any recommendations contained in this publication. Other Forsyth Barr business units may hold views different from those in this publication; any such views will generally not be brought to your attention. Forsyth Barr confirms no inducement has been accepted from the issuer(s) that are the subject of this publication, whether pecuniary or otherwise, in connection with making any recommendation contained in this publication. In preparing this publication, non-financial assistance (for example, access to staff or information) may have been provided by the issuer(s) being researched.

Investment banking engagements: Other than confidential engagements, Forsyth Barr has not within the past 12 months been engaged to provide investment banking services to the issuer that is the subject of this publication. For information about whether Forsyth Barr has within the past 12 months been engaged to provide investment banking services to any other issuer referred to in this publication, please refer to the most recent research report for that issuer's financial products.

Not personalised financial advice: The recommendations and opinions in this publication do not take into account your personal financial situation or investment goals. The financial products referred to in this publication may not be suitable for you. If you wish to receive personalised financial advice, please contact your Forsyth Barr Investment Adviser. The value of financial products may go up and down and investors may not get back the full (or any) amount invested. Past performance is not necessarily indicative of future performance. Disclosure statements for Forsyth Barr Investment Advisers are available on request and free of charge.

Disclaimer: This publication has been prepared in good faith based on information obtained from sources believed to be reliable and accurate. However, that information has not been independently verified or investigated by Forsyth Barr. Forsyth Barr does not make any representation or warranty (express or implied) that the information in this publication is accurate or complete, and, to the maximum extent permitted by law, excludes and disclaims any liability (including in negligence) for any loss which may be incurred by any person acting or relying upon any information, analysis, opinion or recommendation in this publication. Forsyth Barr does not undertake to keep current this publication; any opinions or recommendations may change without notice to you. Any analyses or valuations will typically be based on numerous assumptions; different assumptions may yield materially different results. Nothing in this publication should be construed as a solicitation to buy or sell any financial product, or to engage in or refrain from doing so, or to engage in any other transaction. This publication is not intended to be distributed or made available to any person in any jurisdiction where doing so would constitute a breach of any applicable laws or regulations or would subject Forsyth Barr to any registration or licensing requirement within such jurisdiction.

Terms of use: Copyright Forsyth Barr Limited. You may not redistribute, copy, revise, amend, create a derivative work from, extract data from, or otherwise commercially exploit this publication in any way. By accessing this publication via an electronic platform, you agree that the platform provider may provide Forsyth Barr with information on your readership of the publications available through that platform.