

Meridian Energy

In a State of Flux – FY20 Result Review

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OUTPERFORM

Meridian Energy (MEL) delivered the expected record FY20 result, with EBITDAF up +2% on the very strong FY19 performance. However, NZAS is the main focus at present, but there was little new information. MEL and the industry remains in a state of flux, awaiting a decision on whether NZAS will remain open for a little longer. Speaking of Flux, that was the only modest disappointment, with the IT migration project delayed and the UK revenue outlook uncertain. We've made little change to our forecasts, with the +70cps (+15%) increase in our target price driven by cost of capital changes.

NZX Code	MEL	Financials: Jun/	20A	21E	22E	23E	Valuation (x)	20A	21E	22E	23E
Share price	NZ\$5.20	NPAT* (NZ\$m)	510.3	466.9	384.0	361.0	EV/EBITDA	17.4	18.7	22.3	23.4
Target price	NZ\$5.50	EPS* (NZc)	19.9	18.2	15.0	14.1	EV/EBIT	27.3	30.4	40.9	44.2
Risk rating	Low	EPS growth* (%)	5.9	-8.5	-17.8	-6.0	PE	26.1	28.5	34.7	36.9
Issued shares	2563.0m	DPS (NZc)	19.3	16.9	16.9	16.9	Price / NTA	2.7	2.7	2.9	3.0
Market cap	NZ\$13,328m	Imputation (%)	75	80	75	65	Cash div yld (%)	3.7	3.2	3.2	3.2
Avg daily turnover	1,753k (NZ\$8,396k)	*Based on normalised profits					Gross div yld (%)	4.8	4.3	4.2	4.1

Delivering another record result – but Flux a slight negative

A year ago, after MEL's stellar FY19 result, we were reasonably confident that result wouldn't be repeated, but it has been. FY20 EBITDAF was NZ\$854m, +NZ\$16m higher than FY19. Record generation volumes (above 14TWh for the first time) and continued retail improvement (volumes up +18% and average selling price up +3%) more than offset lower wholesale electricity prices, the 2H HVDC outage and increased opex. Normalised NPAT of NZ\$317m was -5% lower than FY19 due to increased depreciation.

Final dividend pitched at bottom of the dividend policy payout range – 75%

MEL's final dividend of 11.2cps (86% imputed) takes its FY20 dividend to 16.9cps, up +3%. As previously indicated the "special" dividends have ceased so the total FY20 dividend of 19.3cps is -9% lower than FY19. Looking ahead, investors should expect flat dividends of 16.9cps, with growth not resuming for several years. If NZAS delays closure, that should bring dividend growth forward.

No new news on NZAS, mitigation work ongoing

There was no new news on NZAS, with the negotiation ball currently in the government's court. However, mitigation work continues. MEL confirmed its Harapaki wind farm in Hawkes Bay has been deferred (good news). MEL has a little bit of time available, with resource consents expiring at the end of 2023. We expect that if NZAS does remain open a little longer Harapaki will get the go-ahead fairly quickly. Encouragingly, MEL indicated there is strong interest for new South Island demand, including dairy factory coal-boiler conversions data centres, hydrogen and carbon capture projects. New lower South Island demand is the best outcome for MEL. However, it is unclear how much of the "interest" is simply "tyre-kicking" and none will be ready for at least three years. MEL also reiterated its next best alternative is to grow its retail book, raising the spectre of intense retail price competition.

Modest changes to near-term forecasts, but material increase in DCF valuation due to cost of capital assumption changes

Our base assumption remains that NZAS will close in August 2021 and we have not incorporated anything into our forecasts for increased South Island demand (i.e. risks are to the upside). Our forecasts are little changed, with Transpower's positive transmission announcement offset by UK Flux revenue ending in FY23. However, the lowering of our cost of capital assumption to 5.1% (from 6.8%) has lifted our DCF valuation +48% and is the main driver behind the +15% increase in our target price to NZ\$5.50/share.

Meridian Energy Limited (MEL)

Priced as at 26 Aug 2020 (NZ\$)						5.20						
12-month target price (NZ\$)*						5.50	Spot valuations (NZ\$)					
Expected share price return						5.8%	1. DCF					5.22
Net dividend yield						3.2%	2. Market multiple					5.29
Estimated 12-month return						9.0%	3. Dividend yield					5.46
Key WACC assumptions						DCF valuation summary (NZ\$m)						
Risk free rate						1.30%	Total firm value					15,003
Equity beta						0.81	(Net debt)/cash					(1,616)
WACC						5.1%	Less: Capitalised operating leases					
Terminal growth						1.5%	Value of equity					13,387
Profit and Loss Account (NZ\$m)						Valuation Ratios						
	2019A	2020A	2021E	2022E	2023E		2019A	2020A	2021E	2022E	2023E	
Sales revenue	4,104.0	4,102.0	3,535.3	2,962.1	2,900.8	EV/EBITDA (x)	17.6	17.4	18.7	22.3	23.4	
Normalised EBITDA	838.0	855.0	799.2	669.5	639.0	EV/EBIT (x)	26.3	27.3	30.4	40.9	44.2	
Depreciation and amortisation	(276.0)	(312.0)	(308.1)	(303.6)	(300.6)	PE (x)	27.6	26.1	28.5	34.7	36.9	
Normalised EBIT	562.0	543.0	491.1	365.9	338.4	Price/NTA (x)	2.5	2.7	2.7	2.9	3.0	
Net interest	(83.0)	(84.0)	(78.5)	(80.4)	(84.9)	Free cash flow yield (%)	4.2	4.1	3.2	2.5	2.8	
Associate income & other	(7.0)	(219.0)	(22.0)	(4.0)	0	Net dividend yield (%)	4.1	3.7	3.2	3.2	3.2	
Tax	(133.0)	(63.0)	(107.8)	(77.0)	(69.0)	Gross dividend yield (%)	5.1	4.8	4.3	4.2	4.1	
Minority interests	0	0	0	0	0	Capital Structure						
Reported NPAT	339.0	177.0	282.8	204.6	184.5	Interest cover EBIT (x)	6.7	3.9	6.0	4.5	4.0	
Abnormals/other	143.0	333.3	184.1	179.4	176.5	Interest cover EBITDA (x)	10.1	10.2	10.2	8.3	7.5	
Adjusted normalised NPAT	482.0	510.3	466.9	384.0	361.0	Net debt/ND+E (%)	76.9	96.6	106.5	124.0	149.1	
Normalised EPS (cps)	18.8	19.9	18.2	15.0	14.1	Net debt/EBITDA (x)	1.7	1.9	2.0	2.6	2.8	
DPS (cps)	21.3	19.3	16.9	16.9	16.9	Key Ratios						
Growth Rates							2019A	2020A	2021E	2022E	2023E	
Revenue (%)	24.5	0.0	-13.8	-16.2	-2.1	Return on assets (%)	5.7	3.4	5.1	4.0	3.8	
EBITDA (%)	25.8	2.0	-6.5	-16.2	-4.5	Return on equity (%)	6.1	6.3	5.7	4.4	4.2	
EBIT (%)	41.2	-3.4	-9.6	-25.5	-7.5	Return on funds employed (%)	5.9	5.8	5.4	4.1	3.9	
Normalised NPAT (%)	33.6	5.9	-8.5	-17.8	-6.0	EBITDA margin (%)	20.4	20.8	22.6	22.6	22.0	
Normalised EPS (%)	33.6	5.9	-8.5	-17.8	-6.0	EBIT margin (%)	13.7	13.2	13.9	12.4	11.7	
Ordinary DPS (%)	10.9	-9.2	-12.6	0.0	0.0	Capex to sales (%)	1.7	1.5	2.1	4.7	1.9	
Cash Flow (NZ\$m)							2019A	2020A	2021E	2022E	2023E	
EBITDA	838.0	855.0	799.2	669.5	639.0	Capex to depreciation (%)	28	22	27	50	20	
Working capital change	(36.0)	49.0	(44.2)	3.6	(15.2)	Imputation (%)	66	75	80	75	65	
Interest & tax paid	(200.0)	(251.0)	(230.0)	(202.1)	(199.0)	Pay-out ratio (%)	113	97	93	113	120	
Other	33.0	(48.0)	(22.0)	(4.0)	0	Operating Performance						
Operating cash flow	635.0	605.0	503.0	467.0	424.8	Hydro generation	12,326	12,758	12,353	10,600	11,113	
Capital expenditure	(69.0)	(63.0)	(75.4)	(139.4)	(55.4)	Wind generation	1,244	1,466	1,429	1,429	1,429	
(Acquisitions)/divestments	0	(2.0)	0	0	0	Total NZ generation (GWh)	13,570	14,224	13,782	12,029	12,543	
Other	0	0	0	0	0	GWAP (\$/MWh)	123	89	85	55	45	
Funding available/(required)	566.0	540.0	427.6	327.6	369.4	Overseas generation (GWh)	730	642	771	810	810	
Dividends paid	(500.0)	(546.0)	(433.1)	(433.1)	(433.1)	Overseas GWAP (\$/MWh) (NZD)	269	381	366	376	384	
Equity raised/(returned)	(2.0)	(2.0)	0	0	0	Overseas customer numbers (000)	110	136	159	174	183	
(Increase)/decrease in net debt	64.0	(8.0)	(5.5)	(105.5)	(63.8)	NZ electricity customers (000)	302	324	349	380	407	
Balance Sheet (NZ\$m)							2019A	2020A	2021E	2022E	2023E	
Working capital	(24.0)	(64.0)	(3.4)	(9.5)	(1.4)	Average usage per cust (MWh/yr)	13.2	13.9	13.8	13.8	13.7	
Fixed assets	8,825.0	8,594.0	8,366.0	8,202.9	7,957.4	Mass market volumes	3,901	4,342	4,657	5,023	5,382	
Intangibles	59.0	65.0	60.4	59.2	59.6	Time of use volumes	2,338	3,034	3,594	4,205	4,624	
Right of use asset	0	0	0	0	0	Total fixed price volumes (GWh)	6,239	7,376	8,251	9,228	10,006	
Other assets	383.0	441.0	419.0	415.0	415.0	NZAS sales	5,310	5,431	5,011	842	0	
Total funds employed	9,243.0	9,036.0	8,841.9	8,667.6	8,430.6	Sell CFDs	2,239	2,527	1,902	2,902	2,792	
Net debt/(cash)	1,424.0	1,616.0	1,621.5	1,727.0	1,790.8	Buy CFDs	(1,965)	(2,731)	(1,995)	(1,496)	(1,496)	
Lease liability	0	0	0	0	0	Total Sales (GWh)	11,823	12,603	13,169	11,476	11,302	
Other liabilities	2,362.0	2,337.0	2,293.3	2,248.6	2,203.5	Average FPV price (\$/MWh)	105	108	105	98	94	
Shareholder's funds	5,457.0	5,083.0	4,927.1	4,692.0	4,436.3	LWAP (\$/MWh)	132	95	94	65	56	
Minority interests	0	0	0	0	0	LWAP/GWAP	1.07	1.06	1.11	1.18	1.25	
Total funding sources	9,243.0	9,036.0	8,841.9	8,667.6	8,430.6	Lines losses (%)	5.9	4.8	5.5	5.5	5.5	

Forecast changes and target price

With MEL's result in line with expectations our forecast changes are relatively minor. Outlook commentary from MEL was limited to some specific guidance on opex (NZ\$261m to NZ\$266m vs. NZ\$258m in FY20) and capex (NZ\$70m to NZ\$80m vs. NZ\$64m in FY20). Included in the capex guidance is NZ\$20m to NZ\$25m of growth capex which relates to the migration of Meridian branded retail accounts to the internally developed Flux IT platform. However, the project is taking longer than expected, with the completion date pushed back 9 months to September 2021 at an additional cost of +NZ\$17m (which will impact FY22 capex).

The biggest forecast changes have been made to the mix of FY23 EBITDAF. With Transpower indicating the lower South Island transmission project will be completed a year earlier (May 2022), we have lifted our FY23 generation forecast. However, that benefit has been largely offset by news that UK Flux revenue, which is above NZ\$10m per annum, is at risk with E.ON (the new owner of npower) deciding to use Kraken, an alternative billing platform. That has reduced FY23 Other Revenue -NZ\$14m.

The only other change of any note is modestly lower opex, with MEL indicating FY22 and FY23 maintenance costs will be reduced as its asset maintenance program is rejigged to better align with the effects of NZAS closing.

Figure 1. Forecast changes

	FY21	FY21		FY22	FY22		FY23	FY23	
	Old	New	Chg	Old	New	Chg	Old	New	Chg
	NZ\$m	NZ\$m	%	NZ\$m	NZ\$m	%	NZ\$m	NZ\$m	%
NZ Energy Margin	1,056	1,049	-0.6%	904	901	-0.3%	877	884	0.8%
Australia Energy Margin	107	110	3.1%	111	114	3.2%	116	113	-2.6%
Energy margin	1,162	1,159	-0.3%	1,015	1,015	0.1%	993	996	0.4%
Other revenue	29	27	-6.1%	29	27	-7.8%	30	16	-48.2%
Transmission & metering costs	(127)	(125)	-1.9%	(127)	(125)	-2.2%	(126)	(123)	-2.2%
Operating costs	(272)	(268)	-1.5%	(260)	(255)	-1.9%	(264)	(256)	-2.9%
EBITDAF	792	794	0.2%	657	663	0.9%	632	632	-0.1%
Depn & amort	(311)	(308)	-0.9%	(307)	(304)	-1.0%	(305)	(301)	-1.3%
EBIT	481	485	0.8%	350	359	2.6%	328	331	1.1%
Net interest	(79)	(78)	-1.1%	(77)	(80)	4.2%	(82)	(85)	3.0%
FV mvmts, assoc inc, other	(22)	(22)	0.0%	-	(4)	-	-	-	-
Pre-tax profit	380	385	1.3%	273	275	0.7%	245	246	0.5%
Tax	(106)	(108)	1.3%	(76)	(77)	0.7%	(69)	(69)	0.5%
NPAT	274	277	1.3%	197	198	0.7%	177	177	0.5%
Dividend (cps)	16.9	16.9	-0.1%	16.9	16.9	-0.1%	16.9	16.9	-0.1%
Normalised EPS	10.1	10.2	1.4%	7.7	7.6	-0.7%	6.9	6.9	0.5%
Operating statistics			Diff			Diff			Diff
NZ generation (GWh)	13,783	13,782	0.0%	12,030	12,029	0.0%	12,030	12,543	4.3%
FPVV sales (GWh)	8,218	8,251	0.4%	9,199	9,228	0.3%	9,979	10,006	0.3%
Customer numbers (000)	349	349	0.1%	379	380	0.1%	406	407	0.2%
GWAP (\$/MWh)	\$81.5	\$85.0	4.3%	\$53.9	\$55.0	2.0%	\$49.7	\$45.1	-9.2%

Source: Forsyth Barr analysis

Our cost of capital assumption has fallen to 5.1% from 6.8%, which has had a material effect on our DCF valuation, lifting it +48% to NZ\$5.22. That in turn has increased our target price +15% to NZ\$5.50. With interest rates continuing their downward pattern, and additional upside to our forecasts if NZAS remains open or the potential new South Island demand comes to fruition, we retain our OUTPERFORM rating.

Figure 2. Target price changes

NZ\$/share	Old	New	% chg
DCF (40%)	\$3.54	\$5.22	48%
Market multiple (20%)	\$5.25	\$5.29	1%
Dividend yield (40%)	\$5.39	\$5.46	1%
Weighted average	\$4.62	\$5.33	15%
Target price	\$4.80	\$5.50	15%

Source: Forsyth Barr analysis

Result summary

Figure 3. FY20 result summary

	FY19	FY20	%	FB	Diff	
	NZ\$m	NZ\$m	Chg	NZ\$m	NZ\$m	Comments
NZ Energy Margin	1,108	1,122	1%	1,123	(1)	Increase in retail sales volumes (+18%), prices (+3%), generation volumes (+5%) offset lower wholesale prices and HVDC outage impact
Aus Energy Margin	118	122	3%	123	(1)	Improved electricity (+24%) & gas (+310%) sales offset lower generation (-12%) & w/sale prices
Energy Margin	1,226	1,244	1%	1,245	(1)	
Other revenue	25	27	8%	26	1	
Transmission costs	(131)	(123)	-6%	(123)	0	Transmission costs reduced due to lower transmission prices from 1 April 2020
Operating costs	(282)	(294)	4%	(288)	(6)	NZ\$6m provision taken on Holidays Act payroll remediation
EBITDAF	838	854	2%	861	(7)	Another record result for MEL
Depn & amort	(276)	(312)	13%	(314)	2	Lift in depreciation due to FY19 upwards asset revaluations
EBIT	562	542	-4%	547	(5)	
Net interest	(83)	(84)	1%	(84)	0	
FV mvmts, other	(7)	(219)		(10)	(209)	Includes -\$58m asset impairment of Australian wind assets
Pre-tax profit	472	239	-49%	453	(214)	
Tax	(133)	(63)	-53%	(127)	64	
NPAT	339	176	-48%	326	(150)	
Normalised NPAT	333	317	-5%	312	5	Down on pcp due to increase in depreciation
EPS (cps)	13.0	12.4	-5%	12.2	0.2	
Dividend (cps)	21.3	19.3	-9%	19.1	0.2	No special dividend due to capital management plan being cancelled in light of NZAS closure
Final dividend (cps)	13.2	11.2	-15%	11.0	0.2	Full year ordinary dividend of 16.9cps, 86% imputed
Operating statistics						
Generation (GWh)	13,570	14,224	5%	14,224	0	Record generation with increased wind availability and 115% of average hydro inflows
FPVV sales (GWh)	6,239	7,376	18%	7,376	0	+30% increase in corporate sales. Big lift in agricultural sales volumes
Customer numbers	302	324	7%	324	0	Increase in customer numbers, and improved retention rate
GWAP (\$/MWh)	123	89	-28%	91	(2)	Big drop in wholesale electricity prices, but still above average
Summary cashflow						
Operating cash flow	635	605	-5%			
Interest paid	(76)	(78)	3%			
Tax paid	(124)	(173)	40%			Large increase in tax paid due to strong FY19 result
Maintenance capex	(48)	(45)	-6%			
Free cash flow	387	309	-20%			

Source: MEL, Forsyth Barr analysis

Other key points to note from the result include:

- Included in the results are:
 - an NZ\$5m provision if December 2019 prices are reset in line with the Electricity Authority's draft UTS
 - +NZ\$6m benefit from adopting IFRS 16 (lease accounting)
 - increased asset maintenance costs (+NZ\$5m)
 - +NZ\$5m increase in doubtful debt provision to allow for negative COVID-19 impacts
- The -NZ\$58m asset impairment mainly relates to wind generation assets in Australia
- Fair value movements were very large (and negative) in FY20, totalling -NZ\$141m. These are non-cash adjustments and are backed out when calculating normalised NPAT
- The financial statements contain no adjustments for the NZAS closure announcement as that occurred post-balance date. However, MEL notes that the asset impairment impact (net of tax) would be -20cps to -38cps if NZAS closed in August 2021.

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.

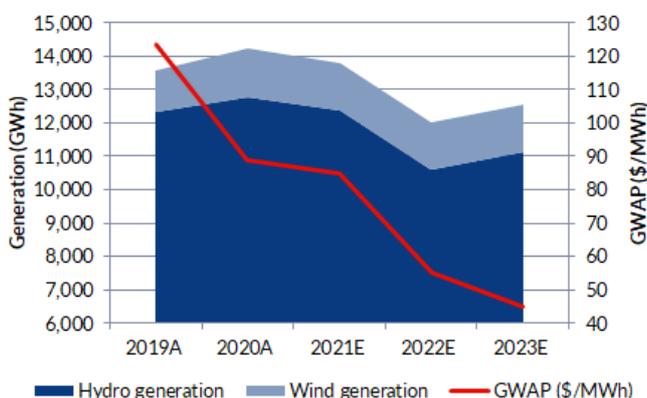
Financial structure

- **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

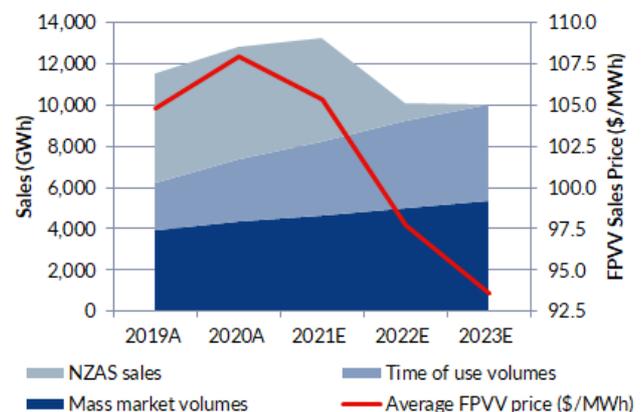
- **Political/regulatory:** The 2014 election and recent Electricity Price Review (EPR) highlighted the political/regulatory risks inherent in the sector. Whilst the EPR gave the sector a thumbs up in most areas, the political risk is unlikely to ever disappear.
- **NZAS closure:** Rio Tinto (RIO) has 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 4. Generation and average price received

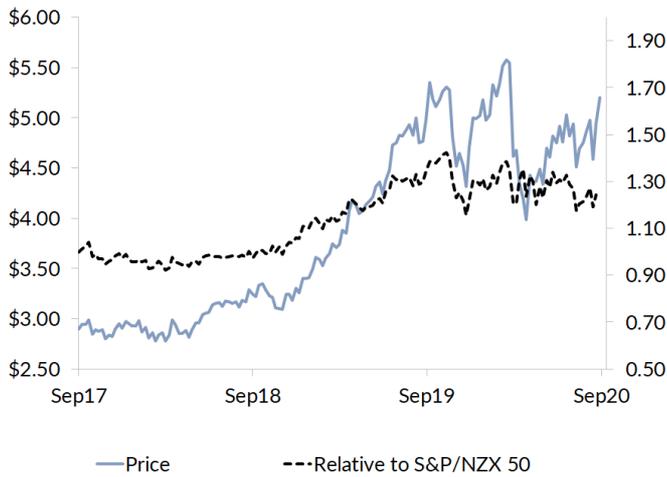


Source: MEL, Forsyth Barr analysis

Figure 5. Retail sales volumes and average retail price



Source: MEL, Forsyth Barr analysis

Figure 6. Price performance


Source: Forsyth Barr analysis

Figure 7. Substantial shareholders

Shareholder	Latest Holding
NZ Govt	51.0%

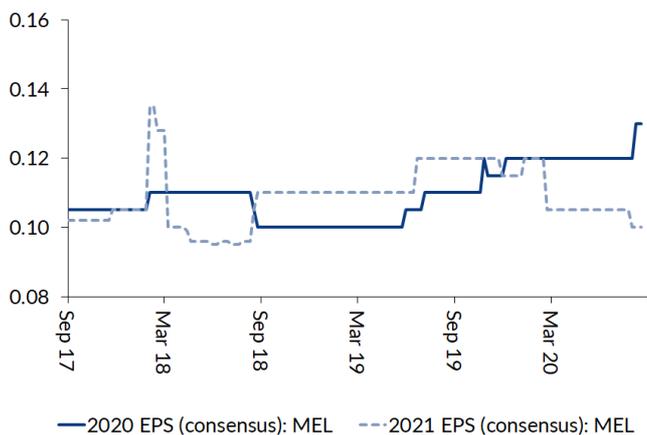
Source: NZX, Forsyth Barr analysis, NOTE: based on SPH notices only

Figure 8. International valuation comparisons

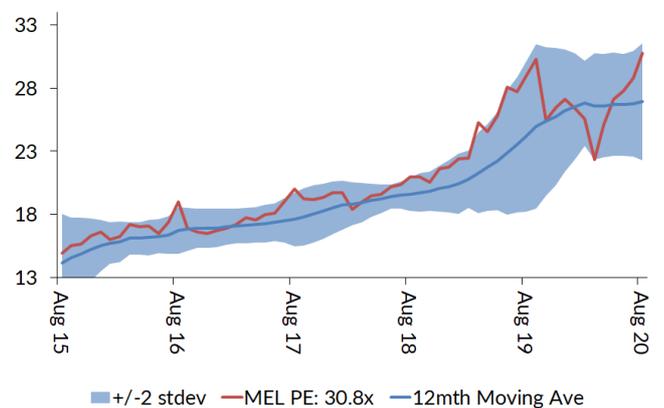
Company	Code	Price	Mkt Cap (m)	PE		EV/EBITDA		EV/EBIT		Cash Yld
				2021E	2022E	2021E	2022E	2021E	2022E	
Meridian Energy	MEL NZ	NZ\$5.20	NZ\$13,328	28.5x	34.7x	18.7x	22.3x	30.4x	40.8x	3.2%
CONTACT ENERGY *	CEN NZ	NZ\$6.26	NZ\$4,496	19.7x	22.4x	12.6x	13.9x	30.0x	32.7x	5.1%
GENESIS ENERGY *	GNE NZ	NZ\$3.03	NZ\$3,138	17.2x	16.7x	11.0x	11.7x	23.9x	28.8x	4.6%
MERCURY *	MCY NZ	NZ\$5.26	NZ\$7,159	26.4x	29.0x	16.3x	16.8x	28.5x	31.3x	3.2%
TRUSTPOWER *	TPW NZ	NZ\$6.78	NZ\$2,122	24.2x	24.4x	14.4x	14.5x	19.1x	19.3x	4.4%
AGL ENERGY	AGLAT	A\$14.91	A\$9,291	14.7x	17.4x	6.7x	7.4x	11.5x	13.9x	5.5%
INFIGEN ENERGY	IFNAT	A\$0.92	A\$893	>50x	n/a	n/a	n/a	n/a	n/a	n/a
ORIGIN ENERGY	ORG AT	A\$5.45	A\$9,599	22.7x	15.3x	6.3x	5.6x	21.1x	15.8x	4.4%
Compcp Average:				20.8x	20.9x	11.2x	11.7x	22.4x	23.6x	4.5%
MEL Relative:				37%	66%	67%	92%	36%	73%	-28%

EV = Current Market Cap + Actual Net Debt

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

Figure 9. Consensus EPS momentum (NZ\$)


Source: Forsyth Barr analysis

Figure 10. One year forward PE (x)


Source: Forsyth Barr analysis

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