

# Meridian Energy

## Gravity Defying Hydro

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### UNDERPERFORM

We are downgrading our Meridian Energy (MEL) rating to UNDERPERFORM from NEUTRAL following its recent share price surge and increase in interest rates (which should be a negative for yield stocks). MEL is now trading on a record low cash dividend yield of 2.8% (gross dividend yield of 3.6%) and the spread between MEL's gross dividend yield and the 10-year swap rate is below 3.0% for the first time. Other yield and electricity investments offer better value, in our view.

NZX Code	MEL	Financials: Jun/	20A	21E	22E	23E	Valuation (x)	20A	21E	22E	23E
Share price	NZ\$6.08	NPAT* (NZ\$m)	510.3	446.1	383.1	365.5	PE	30.5	34.9	40.7	42.6
Target price	NZ\$5.50	EPS* (NZc)	19.9	17.4	14.9	14.3	EV/EBIT	31.5	37.2	46.2	49.9
Risk rating	Low	EPS growth* (%)	5.9	-12.6	-14.1	-4.6	EV/EBITDA	20.0	22.3	25.4	26.7
Issued shares	2563.0m	DPS (NZc)	19.3	16.9	16.9	16.9	Price / NTA	3.1	3.2	3.4	3.6
Market cap	NZ\$15,583m	Imputation (%)	75	75	75	65	Cash div yld (%)	3.2	2.8	2.8	2.8
Avg daily turnover	1,837k (NZ\$9,013k)	*Based on normalised profits					Gross div yld (%)	4.1	3.6	3.6	3.5

#### What's changed?

- **Earnings:** FY21 EBITDAF increased +NZ\$17m (+2.3%) to NZ\$765m
- **Target price:** Increased +6cps (+1.1%) to NZ\$5.50
- **Rating:** Downgraded to UNDERPERFORM from NEUTRAL

#### Dividend yield relative to interest rates sinks to new low

As a result of market movements the spread between MEL's gross dividend yield and the 10-year swap rate has collapsed to a record low 2.8%. On no news flow, MEL's share price has surged +23% since the end of September 2020 to record highs over NZ\$6.00. Over the same period, the 10-year swap rate has also increased +36 basis points to 0.86%, the highest since early June 2020. With dividend growth likely to be muted in the next few years (at best) MEL is an expensive defensive, in our view.

#### High share price creates asymmetric downside risk to NZAS closing

The market appears to be assuming that NZAS will remain open. Whilst that appears the most likely scenario, it is not a fait accompli. The share price run has been such that there is now asymmetric risk to the downside, with limited/no share price upside if Rio Tinto decides to keep NZAS open for longer. Our current FY21 dividend forecast of 16.9cps is unlikely to change if NZAS remains open beyond August 2021 for two reasons. First, if NZAS remains open, we estimate that average hydro EBITDAF will be between NZ\$700m to NZ\$720m, supporting a dividend of 16.5cps to 16.9cps at the top end of MEL's dividend pay out policy range. Second, if NZAS remains open MEL is likely to build its Hawkes Bay wind farm development option and will need capital for that purpose. We do not expect MEL to reinstate its capital management program (i.e. the 4.88cps special dividend).

#### Strong October operating performance as hydro generation volumes return

We estimate MEL's October 2020 EBITDAF was NZ\$76m, up +NZ\$7m on the prior year. A new record NZ Energy Margin (NZ\$97m, up +NZ\$4m driven by a strong retail performance and above average hydro generation volumes) and lower transmission charges are the main factors behind the strong October operating performance. We have lifted our FY21 EBITDAF forecast +NZ\$17m (+2.3%) to \$765m with retail prices and higher value sales volumes tracking ahead of our old forecast. A recovery in hydro storage has also helped. The increase in our near-term earnings forecast has lifted our target price +6cps to NZ\$5.50.



## Meridian Energy Limited (MEL)

Priced as at 18 Nov 2020 (NZ\$)

6.08

### 12-month target price (NZ\$)\*

5.50

Expected share price return

-9.5%

Net dividend yield

2.8%

Estimated 12-month return

-6.8%

### Key WACC assumptions

Risk free rate

1.30%

Equity beta

0.81

WACC

5.1%

Terminal growth

1.5%

### Spot valuations (NZ\$)

1. DCF

5.25

2. Market multiple

5.07

3. Dividend yield

5.46

### DCF valuation summary (NZ\$m)

Total firm value

15,350

(Net debt)/cash

(1,903)

Less: Capitalised operating leases

Value of equity

13,447

Profit and Loss Account (NZ\$m)	2019A	2020A	2021E	2022E	2023E
Sales revenue	4,104.0	4,102.0	3,654.4	2,960.2	2,896.9
<b>Normalised EBITDA</b>	<b>838.0</b>	<b>855.0</b>	<b>770.9</b>	<b>676.5</b>	<b>645.8</b>
Depreciation and amortisation	(276.0)	(312.0)	(308.1)	(303.6)	(300.6)
<b>Normalised EBIT</b>	<b>562.0</b>	<b>543.0</b>	<b>462.9</b>	<b>372.9</b>	<b>345.2</b>
Net interest	(83.0)	(84.0)	(79.2)	(80.7)	(85.4)
Associate income & other	(7.0)	(219.0)	(22.0)	(12.0)	0
Tax	(133.0)	(63.0)	(99.7)	(76.6)	(70.8)
Minority interests	0	0	0	0	0
<b>Reported NPAT</b>	<b>339.0</b>	<b>177.0</b>	<b>262.0</b>	<b>203.6</b>	<b>189.0</b>
Abnormals/other	143.0	333.3	184.1	179.4	176.5
<b>Adjusted normalised NPAT</b>	<b>482.0</b>	<b>510.3</b>	<b>446.1</b>	<b>383.1</b>	<b>365.5</b>
Normalised EPS (cps)	18.8	19.9	17.4	14.9	14.3
DPS (cps)	21.3	19.3	16.9	16.9	16.9

Growth Rates	2019A	2020A	2021A	2022A	2023A
Revenue (%)	24.5	0.0	-10.9	-19.0	-2.1
EBITDA (%)	25.8	2.0	-9.8	-12.2	-4.5
EBIT (%)	41.2	-3.4	-14.8	-19.4	-7.4
Normalised NPAT (%)	33.6	5.9	-12.6	-14.1	-4.6
Normalised EPS (%)	33.6	5.9	-12.6	-14.1	-4.6
Ordinary DPS (%)	10.9	-9.2	-12.6	0.0	0.0

Cash Flow (NZ\$m)	2019A	2020A	2021E	2022E	2023E
<b>EBITDA</b>	<b>838.0</b>	<b>855.0</b>	<b>770.9</b>	<b>676.5</b>	<b>645.8</b>
Working capital change	(36.0)	49.0	(34.2)	1.4	(15.2)
Interest & tax paid	(200.0)	(251.0)	(222.5)	(202.0)	(201.3)
Other	33.0	(48.0)	(22.0)	(12.0)	0
<b>Operating cash flow</b>	<b>635.0</b>	<b>605.0</b>	<b>492.2</b>	<b>463.9</b>	<b>429.3</b>
Capital expenditure	(69.0)	(63.0)	(75.4)	(139.4)	(55.4)
(Acquisitions)/divestments	0	(2.0)	0	0	0
Other	0	0	0	0	0
<b>Funding available/(required)</b>	<b>566.0</b>	<b>540.0</b>	<b>416.8</b>	<b>324.6</b>	<b>373.8</b>
Dividends paid	(500.0)	(546.0)	(433.1)	(433.1)	(433.1)
Equity raised/(returned)	(2.0)	(2.0)	0	0	0
<b>(Increase)/decrease in net debt</b>	<b>64.0</b>	<b>(8.0)</b>	<b>(16.4)</b>	<b>(108.6)</b>	<b>(59.3)</b>

Balance Sheet (NZ\$m)	2019A	2020A	2021E	2022E	2023E
Working capital	(24.0)	(64.0)	(13.4)	(9.3)	(1.2)
Fixed assets	8,825.0	8,594.0	8,366.0	8,202.9	7,957.4
Intangibles	59.0	65.0	60.4	59.2	59.6
Right of use asset	0	0	0	0	0
Other assets	383.0	441.0	419.0	407.0	407.0
<b>Total funds employed</b>	<b>9,243.0</b>	<b>9,036.0</b>	<b>8,832.0</b>	<b>8,659.8</b>	<b>8,422.8</b>
Net debt/(cash)	1,424.0	1,616.0	1,632.4	1,740.9	1,800.2
Lease liability	0	0	0	0	0
Other liabilities	2,362.0	2,337.0	2,293.3	2,248.6	2,203.5
Shareholder's funds	5,457.0	5,083.0	4,906.3	4,670.3	4,419.1
Minority interests	0	0	0	0	0
<b>Total funding sources</b>	<b>9,243.0</b>	<b>9,036.0</b>	<b>8,832.0</b>	<b>8,659.8</b>	<b>8,422.8</b>

Valuation Ratios	2019A	2020A	2021E	2022E	2023E
EV/EBITDA (x)	20.3	20.0	22.3	25.4	26.7
EV/EBIT (x)	30.3	31.5	37.2	46.2	49.9
PE (x)	32.3	30.5	34.9	40.7	42.6
Price/NTA (x)	2.9	3.1	3.2	3.4	3.6
Free cash flow yield (%)	3.6	3.5	2.7	2.1	2.4
Net dividend yield (%)	3.5	3.2	2.8	2.8	2.8
Gross dividend yield (%)	4.4	4.1	3.6	3.6	3.5

Capital Structure	2019A	2020A	2021E	2022E	2023E
Interest cover EBIT (x)	6.7	3.9	5.6	4.5	4.0
Interest cover EBITDA (x)	10.1	10.2	9.7	8.4	7.6
Net debt/ND+E (%)	76.9	96.6	107.9	125.7	150.9
Net debt/EBITDA (x)	1.7	1.9	2.1	2.6	2.8

Key Ratios	2019A	2020A	2021E	2022E	2023E
Return on assets (%)	5.7	3.4	4.7	4.0	3.9
Return on equity (%)	6.1	6.3	5.3	4.4	4.3
Return on funds employed (%)	5.9	5.8	5.1	4.2	4.0
EBITDA margin (%)	20.4	20.8	21.1	22.9	22.3
EBIT margin (%)	13.7	13.2	12.7	12.6	11.9
Capex to sales (%)	1.7	1.5	2.1	4.7	1.9
Capex to depreciation (%)	28	22	27	50	20
Imputation (%)	66	75	75	75	65
Pay-out ratio (%)	113	97	97	113	118

Operating Performance	2019A	2020A	2021E	2022E	2023E
Hydro generation	12,326	12,758	11,881	10,600	11,113
Wind generation	1,244	1,466	1,447	1,430	1,430
<b>Total NZ generation (GWh)</b>	<b>13,570</b>	<b>14,224</b>	<b>13,328</b>	<b>12,030</b>	<b>12,543</b>
GWAP (\$/MWh)	123	89	93	55	45

Overseas generation (GWh)	730	642	771	810	810
Overseas GWAP (\$/MWh) (NZD)	269	381	365	376	384
Overseas customer numbers (000)	110	136	159	174	183

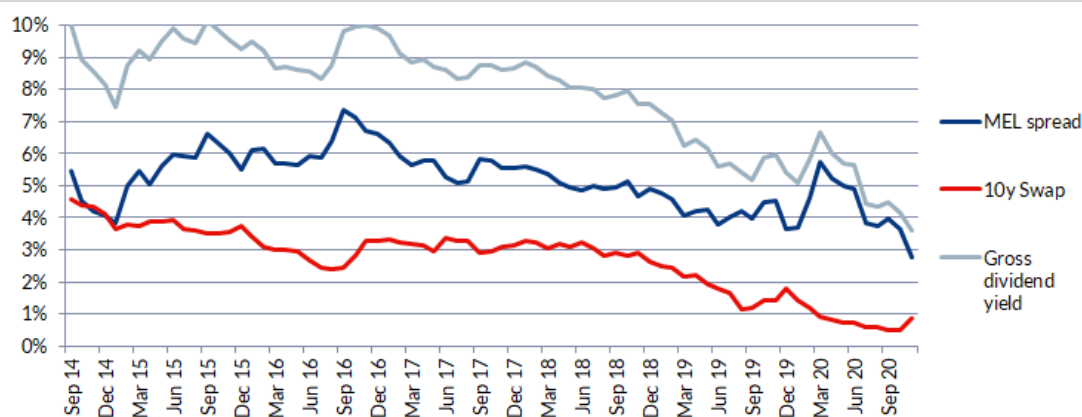
NZ electricity customers (000)	302	324	349	380	407
Average usage per cust (MWh/yr)	13.2	13.9	14.1	14.0	13.9
Mass market volumes	3,901	4,342	4,766	5,108	5,471
Time of use volumes	2,338	3,034	3,467	4,056	4,458
<b>Total fixed price volumes (GWh)</b>	<b>6,239</b>	<b>7,376</b>	<b>8,233</b>	<b>9,165</b>	<b>9,930</b>
NZAS sales	5,310	5,431	5,011	842	0
Sell CFDs	2,239	2,527	1,902	2,902	2,792
Buy CFDs	(1,965)	(2,731)	(2,218)	(1,496)	(1,496)
<b>Total Sales (GWh)</b>	<b>11,823</b>	<b>12,603</b>	<b>12,928</b>	<b>11,413</b>	<b>11,226</b>
Average FPV price (\$/MWh)	105	108	107	99	94

LWAP (\$/MWh)	132	95	104	65	56
LWAP/GWAP	1.07	1.06	1.12	1.18	1.25
Lines losses (%)	5.9	4.8	5.5	5.5	5.5



## Gross dividend yield relative to interest rates falls to new lows

Figure 1. MEL gross dividend yield vs. 10 year swap rate



Source: Refinitiv, Forsyth Barr analysis

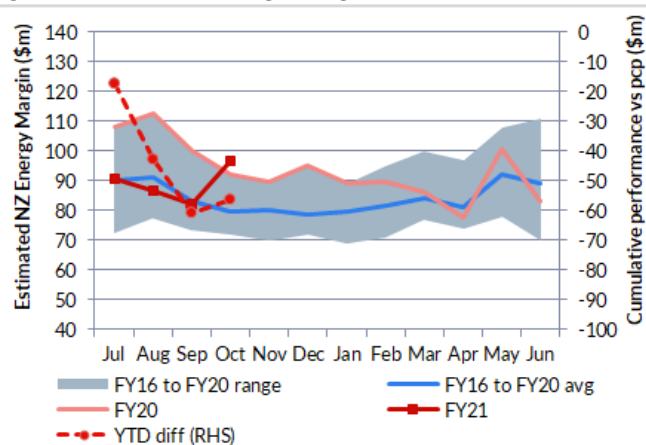
## Strong October 2020 operating performance

Figure 2. October 2020 operating performance

	Oct-19	Oct-20	Diff	YTD Oct-19	YTD Oct-20	Diff
	\$m	\$m	\$m	\$m	\$m	\$m
NZ retail revenue	100	114	14	433	489	56
NZ hedging gain/loss (incl mkt costs)	6	5	(2)	26	17	(9)
NZ generation/wholesale performance	(14)	(22)	(8)	(47)	(150)	(103)
<b>Estimated NZ Energy Margin (NZ\$m)</b>	<b>92</b>	<b>97</b>	<b>4</b>	<b>413</b>	<b>357</b>	<b>(56)</b>
AU retail contribution (A\$m)	2	5	3	6	23	17
AU hedging gain/loss (incl mkt costs) (A\$m)	(0)	(1)	(0)	(0)	(4)	(4)
AU generation/wholesale performance (A\$m)	9	4	(5)	34	16	(18)
<b>Estimated AU Energy Margin (A\$m)</b>	<b>10</b>	<b>8</b>	<b>(2)</b>	<b>41</b>	<b>35</b>	<b>(6)</b>
<b>Estimated AU Energy Margin (NZ\$m)</b>	<b>11</b>	<b>8</b>	<b>(2)</b>	<b>43</b>	<b>37</b>	<b>(6)</b>
Operating costs	(22)	(21)	1	(86)	(84)	2
Est. transmission costs (NZ & Aus)	(11)	(7)	4	(45)	(28)	17
Est. metering costs	(3)	(3)	(0)	(11)	(12)	(1)
Est. other revenue	2	2	0	9	9	0
<b>Est MEL EBITDAF (NZ\$m)</b>	<b>69</b>	<b>76</b>	<b>7</b>	<b>322</b>	<b>278</b>	<b>(44)</b>

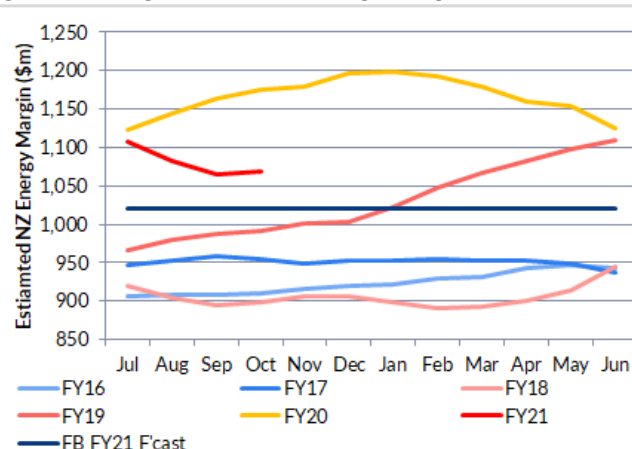
Source: MEL, Forsyth Barr analysis

Figure 3. Historic NZ Energy Margin



Source: MEL, Forsyth Barr analysis

Figure 4. Rolling 12-month NZ Energy Margin



Source: MEL, Forsyth Barr analysis



## Forecast changes

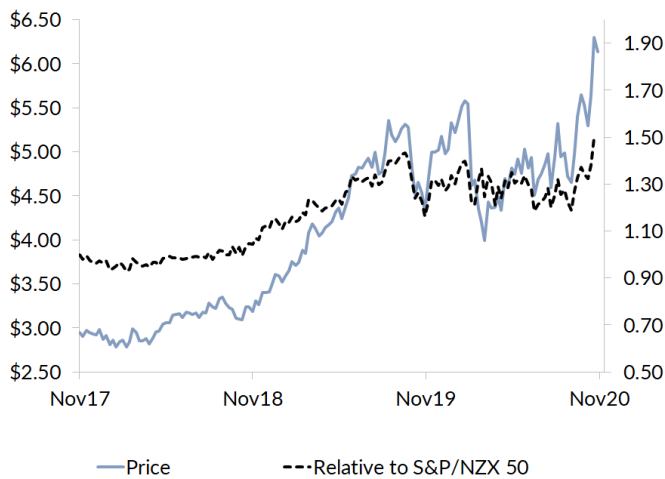
Figure 5. Summary forecast changes

NZ\$m	FY21	FY21	% Chg	FY22	FY22	% Chg	FY23	FY23	% Chg
	Old	New		Old	New		Old	New	
NZ Energy Margin	1,003	1,021	2%	901	908	1%	884	890	1%
Australia Energy Margin	110	110	0%	114	114	0%	113	113	0%
<b>EBITDAF</b>	<b>748</b>	<b>765</b>	<b>2%</b>	<b>663</b>	<b>670</b>	<b>1%</b>	<b>632</b>	<b>639</b>	<b>1%</b>
EBIT	440	457	4%	359	366	2%	331	338	2%
Pre-tax profit	338	356	5%	274	274	0%	245	253	3%
<b>NPAT</b>	<b>244</b>	<b>256</b>	<b>5%</b>	<b>197</b>	<b>197</b>	<b>0%</b>	<b>176</b>	<b>182</b>	<b>3%</b>
FY dividend (cps)	16.9	16.9	0%	16.9	16.9	0%	16.9	16.9	0%
NZ Generation (GWh)	13,294	13,328	0%	12,030	12,030	0%	12,543	12,543	0%
FPVV sales (GWh)	8,251	8,233	0%	9,228	9,165	-1%	10,006	9,930	-1%
Customer numbers (000)	349	349	0%	380	380	0%	407	407	0%
GWAP (\$/MWh)	\$97.2	\$93.1	-4%	\$55.0	\$55.0	0%	\$45.1	\$45.1	0%

Source: Forsyth Barr analysis

**Note:** Our FY22 forecast and beyond assumes NZAS closes in August 2021. To account for the possibility that NZAS remains open beyond August 2021 we have included a +10cps uplift to our target price.



**Figure 6. Price performance**


Source: Forsyth Barr analysis

**Figure 7. Substantial shareholders**

Shareholder	Latest Holding
NZ Govt	51.0%
BlackRock Investment Management	5.0%

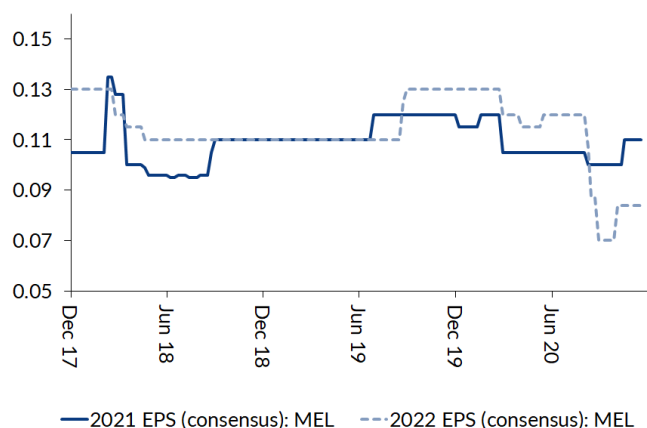
Source: NZX, Forsyth Barr analysis, NOTE: based on SPH notices only

**Figure 8. International valuation comparisons**

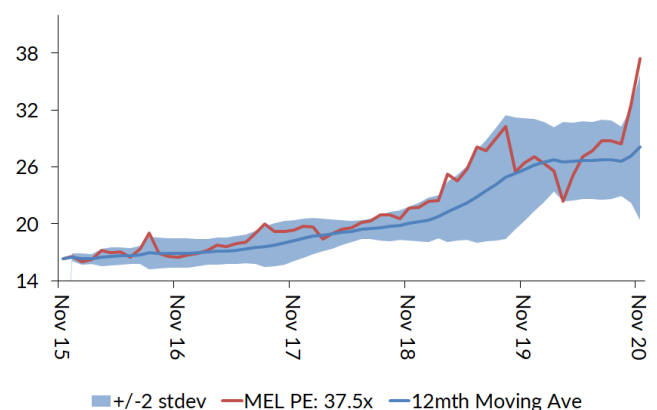
Company	Code	Price	Mkt Cap (m)	PE 2021E	PE 2022E	EV/EBITDA 2021E	EV/EBITDA 2022E	EV/EBIT 2021E	EV/EBIT 2022E	Cash Yld 2022E
(metrics re-weighted to reflect MEL's balance date - June)										
Meridian Energy	MEL NZ	NZ\$6.08	NZ\$15,583	34.9x	40.7x	22.3x	25.4x	37.2x	46.1x	2.8%
CONTACT ENERGY *	CEN NZ	NZ\$8.04	NZ\$5,777	23.3x	28.8x	14.7x	17.2x	32.4x	40.5x	4.0%
GENESIS ENERGY *	GNE NZ	NZ\$3.25	NZ\$3,392	18.0x	17.9x	11.5x	12.4x	24.6x	30.5x	4.3%
MERCURY *	MCY NZ	NZ\$6.00	NZ\$8,174	31.1x	33.1x	18.6x	18.8x	33.4x	35.1x	2.8%
TRUSTPOWER *	TPW NZ	NZ\$7.58	NZ\$2,372	28.8x	30.3x	15.6x	15.9x	20.4x	21.1x	4.0%
AGL ENERGY	AGLAT	A\$12.89	A\$8,031	13.0x	16.2x	6.0x	6.7x	10.3x	12.7x	6.0%
INFIGEN ENERGY	IFNAT	A\$0.93	A\$903	n/a	n/a	10.1x	n/a	20.0x	n/a	n/a
ORIGIN ENERGY	ORG AT	A\$4.88	A\$8,595	23.8x	14.8x	6.1x	5.4x	22.5x	16.2x	4.9%
Compc Average:				23.0x	23.5x	11.8x	12.7x	23.4x	26.0x	4.3%
MEL Relative:				52%	73%	89%	100%	59%	77%	-36%

EV = Current Market Cap + Actual Net Debt

Source: \*Forsyth Barr analysis, Bloomberg Consensus, Compc 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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