FORSYTH BARR

Refining NZ

NEUTRAL

Mike Hikes to CEN — July/August 2019 Operating Statistics

Refining NZ (NZR) has reported July/August 2019 processing fee revenue of $56.2m, +75% more than the prior two month period and gross refining margins (GRM) rebounded. Whilst the GRM and processing fee revenue were a little below expectations, recent weakness in the NZDUSD means we have left our forecast unchanged. The surprise announcement this week has been CEO Mike Fuge's resignation, one year into the job.

What's changed?

- **Earnings:** NPAT unchanged at NZ$43m
- **Target Price:** Unchanged at $2.15
- **Rating:** NEUTRAL rating retained

GRM rebound, but possibly more to go

The July/August 2019 gross refining margin (GRM) of US$7.10/barrel was +$63% higher than the May/June 2019 period as gasoline (petrol) spreads recovered strongly. NZR's GRM uplift over the Singapore complex margin was +US$3.87/barrel — a solid figure, but the lowest uplift since the large refinery outage in May/June 2018. Throughput was strong at 7.42m barrels, the highest figure in 10 months. The processing fee was NZ$56.2m, -$3.7m lower than our estimate for July/August, but +75% higher than the May/June 2019 period, highlighting how difficult those two months were.

We have not changed our FY19 forecasts as whilst the GRM was slightly below expectations, the recent fall in the NZDUSD largely offsets that weakness. As yet, the impact of the forthcoming Marpol regulations do not appear to be having a material impact on NZR's GRM, although we still expect that firmness heading into 4Q19. We estimate the September GRM has averaged US$7.40/barrel and our 2H19 GRM assumption of US$7.75/barrel implicitly assumes an average GRM of US$8.00/barrel for the last four months of 2019.

Surprise CEO resignation, one year into the job

The surprise announcement this week was the resignation of CEO Mike Fuge to take on the CEO role at electricity generator/retailer Contact Energy (CEN). Mr Fuge has only been with NZR for little over a year and having completed a strategy review was moving into the implementation phase. His current departure date is expected to be March 2020.

Pipeline inquiry commends NZR

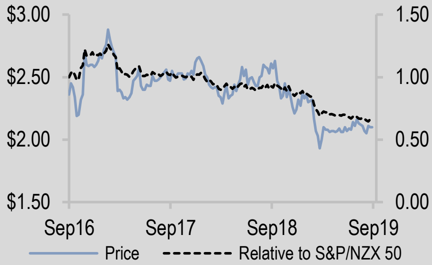
On Tuesday, the Government released its Wiri Pipeline Inquiry report. Whilst we did not expect any downside from the report, it did commend NZR on the pipeline repair and the work it has since done to improve resilience where possible.

Investment View

Our rating is NEUTRAL. NZR's near-term outlook is looking more positive with shipping fuel specification changes likely to be positive in the coming months. However, we see medium-term uncertainties, particularly demand risk as the global economy slows which may weigh on the GRM

NZX Code	NZR
Share price	NZ$2.10
Target price	NZ$2.15
Risk rating	High
Issued shares	312.6m
Market cap	NZ$656m
Average daily turnover	213.7k (NZ$476k)

Share Price Performance



Financials: December	18A	19E	20E	21E
NPAT* (NZ$m)	29.6	43.5	67.2	53.0
EPS* (NZc)	9.5	13.9	21.5	17.0
EPS growth* (%)	-62.3	46.9	54.6	-21.2
DPS (NZc)	7.5	9.0	12.0	12.0
Imputation (%)	100	100	100	100

Valuation (x)	18A	19E	20E	21E
EV/EBITDA	5.7	5.1	4.3	4.7
EV/EBIT	15.6	12.4	8.6	10.9
PE	22.2	15.1	9.8	12.4
Price / NTA	0.9	0.9	0.8	0.8
Cash dividend yield (%)	3.6	4.3	5.7	5.7
Gross dividend yield (%)	5.0	6.0	7.9	7.9

*Historic and forecast numbers based on underlying profits

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

Refining NZ (NZR) Priced as at 18 Sep 2019: NZ$2.10 December year end

Forsyth Barr valuation			
Valuation methodology	Blend of spot valuations, weighted to multiples		
12-month target price (NZ$)*	**2.15**	**Spot valuations (NZ$)**	
Expected share price return	2.4%	1. DCF	2.06
Net dividend yield	5.4%	2. Market multiples	2.10
Estimated 12-month return	7.7%	3. n/a	n/a
Key WACC assumptions		**DCF valuation summary (NZ$m)**	
Risk free rate	2.00%	Total firm value	922
Equity beta	1.00	(Net debt)/cash	(274)
WACC	8.5%	Value of equity	647
Terminal growth	0.0%	Shares (m)	313

Profit and Loss Account (NZ$m)	**2017A**	**2018A**	**2019E**	**2020E**	**2021E**
Sales revenue	414.6	362.5	408.0	431.3	416.6
Normalised EBITDA	**220.3**	**152.6**	**177.2**	**206.6**	**188.5**
Depreciation and amortisation	(96.1)	(97.1)	(104.5)	(104.0)	(107.0)
Normalised EBIT	**124.2**	**55.6**	**72.7**	**102.6**	**81.5**
Net interest	(13.7)	(13.8)	(12.2)	(9.2)	(7.9)
Associate income	-	-	-	-	-
Tax	(31.9)	(12.2)	(17.0)	(26.1)	(20.6)
Minority interests	-	-	-	-	-
Normalised NPAT	**78.5**	**29.6**	**43.5**	**67.2**	**53.0**
Abnormals/other	-	-	-	-	-
Reported NPAT	**78.5**	**29.6**	**43.5**	**67.2**	**53.0**
Normalised EPS (cps)	25.1	9.5	13.9	21.5	17.0
DPS (cps)	18.0	7.5	9.0	12.0	12.0

Growth Rates	**2017A**	**2018A**	**2019E**	**2020E**	**2021E**
Revenue (%)	17.1	-12.6	12.6	5.7	-3.4
EBITDA (%)	31.7	-30.7	16.1	16.6	-8.8
EBIT (%)	55.2	-55.3	30.8	41.1	-20.6
Normalised NPAT (%)	66.5	-62.3	46.9	54.6	-21.2
Normalised EPS (%)	66.5	-62.3	46.9	54.6	-21.2
DPS (%)	100.0	-58.3	20.0	33.3	0.0

Cash Flow (NZ$m)	**2017A**	**2018A**	**2019E**	**2020E**	**2021E**
EBITDA	**220.3**	**152.6**	**177.2**	**206.6**	**188.5**
Working capital change	22.5	(38.8)	(13.6)	4.0	0.2
Interest & tax paid	(36.9)	(25.2)	(38.6)	(35.4)	(28.5)
Other	(8.0)	16.0	11.4	-	-
Operating cash flow	**198.0**	**104.6**	**136.5**	**175.3**	**160.2**
Capital expenditure	(94.6)	(162.3)	(79.6)	(100.3)	(93.6)
(Acquisitions)/divestments	-	-	-	-	-
Other	(0.4)	-	-	-	-
Funding available/(required)	**103.1**	**(57.7)**	**56.9**	**75.0**	**66.6**
Dividends paid	(37.5)	(46.9)	(20.3)	(34.4)	(37.5)
Equity raised/(returned)	(0.7)	(0.3)	(0.3)	-	-
Increase/(decrease) in net debt	**(64.8)**	**104.9**	**(36.3)**	**(40.6)**	**(29.1)**

Balance Sheet (NZ$m)	**2017A**	**2018A**	**2019E**	**2020E**	**2021E**
Working capital	(17.0)	19.5	32.1	28.1	27.9
Fixed assets	1,128.9	1,191.9	1,168.7	1,165.0	1,151.6
Intangibles	8.1	14.3	17.9	17.9	17.9
Other assets	-	0.0	0.1	0.1	0.1
Total funds employed	**1,120.1**	**1,225.7**	**1,218.8**	**1,211.0**	**1,197.4**
Net debt/(cash)	155.1	260.3	229.2	188.6	159.4
Other non current liabilities	172.2	195.8	203.8	203.8	203.8
Shareholder's funds	792.3	769.2	785.4	818.2	832.7
Minority interests	0.4	0.4	0.4	0.4	1.4
Total funding sources	**1,120.1**	**1,225.7**	**1,218.8**	**1,211.0**	**1,197.4**

Valuation Ratios	**2017A**	**2018A**	**2019E**	**2020E**	**2021E**
EV/EBITDA (x)	3.8	5.7	5.1	4.3	4.7
EV/EBIT (x)	6.8	15.6	12.4	8.6	10.9
PE (x)	8.4	22.2	15.1	9.8	12.4
Price/NTA (x)	0.8	0.9	0.9	0.8	0.8
Free cash flow yield (%)	15.8	-8.8	8.7	11.4	10.2
Net dividend yield (%)	8.6	3.6	4.3	5.7	5.7
Gross dividend yield (%)	11.9	5.0	6.0	7.9	7.9
Imputation (%)	100	100	100	100	100
Pay-out ratio (%)	72	79	65	56	71

Capital Structure	**2017A**	**2018A**	**2019E**	**2020E**	**2021E**
Interest cover EBIT (x)	9.0	4.0	5.9	11.1	10.4
Interest cover EBITDA (x)	16.0	11.1	14.5	22.4	24.0
Net debt/ND+E (%)	16.4	25.3	22.6	18.7	16.1
Net debt/EBITDA (x)	0.7	1.7	1.3	0.9	0.8

Key Ratios	**2017A**	**2018A**	**2019E**	**2020E**	**2021E**
Return on assets (%)	9.3	4.0	5.2	7.4	5.9
Return on equity (%)	9.9	3.9	5.5	8.2	6.4
Return on funds employed (%)	10.1	4.6	5.8	7.8	6.4
EBITDA margin (%)	53.1	42.1	43.4	47.9	45.2
EBIT margin (%)	30.0	15.3	17.8	23.8	19.6
Capex to sales (%)	22.8	44.8	19.5	23.3	22.5
Capex to depreciation (%)	98	167	76	96	87

Operating Performance	**2017A**	**2018A**	**2019E**	**2020E**	**2021E**
Revenue Breakdown (NZ$m)					
Processing fee revenue	327.4	258.9	302.6	326.5	309.9
Natural gas recovery	24.4	32.0	39.8	40.6	41.4
Other refining revenue	11.7	13.6	14.8	13.5	13.8
Pipeline revenue	37.8	44.1	37.0	37.8	38.5
Other revenue	13.3	13.9	13.9	12.9	13.0
Total revenue	**414.6**	**362.5**	**408.0**	**431.3**	**416.6**
Processing fee revenue growth (%)	18.4	-20.9	16.9	7.9	-5.1
Total revenue growth (%)	17.1	-12.6	12.6	5.7	-3.4
Processing fee drivers					
Refining margin (USD/barrel)	8.0	6.2	6.6	7.4	7.0
NZDUSD	0.71	0.69	0.66	0.68	0.68
Throughput (mbls)	41.7	40.4	43.4	43.0	43.0
Refining margin (NZD/barrel)	7.9	6.2	6.9	7.6	7.2
Margin cap (USD/barrel)	9.0	9.0	9.0	9.0	9.0
Fee floor (estimated) (USD/barrel)	3.2	3.3	3.0	3.1	3.2
Operating cost breakdown (NZ$m)					
Process materials and utilities	45.9	49.2	59.6	54.1	54.4
Natural gas costs	24.4	32.0	39.8	40.6	41.4
Materials & contractor payments	31.0	29.0	31.1	31.5	31.8
Wages & salaries	59.0	61.3	62.3	63.6	64.9
Admin & other expenses	33.8	38.4	38.0	35.0	35.7
Total expenses	**194.3**	**209.8**	**230.8**	**224.7**	**228.1**

* Forsyth Barr target prices reflect valuation rolled forward at cost of equity less the next 12-months dividend

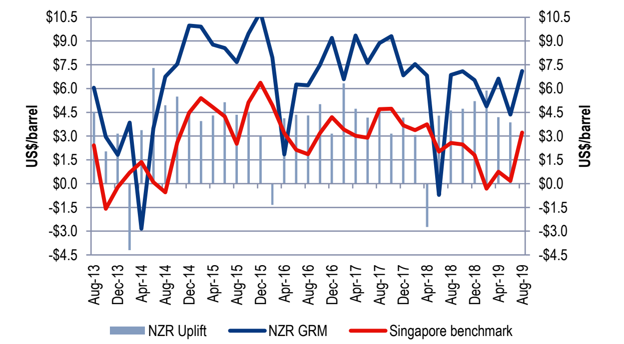
July/August 2019 operating statistics

Figure 1. July/August 2019 operating statistics

	Jul/Aug 2018	May/Jun 2019	Jul/Aug 2019	% Diff pcp	% Diff mom
Throughput (000 barrels)	7,615	6,945	7,419	-3%	7%
Gross refining margin (US$/barrel)	$6.86	$4.36	$7.10	3%	63%
NZDUSD	0.673	0.658	0.656	-3%	0%
NZD processing revenue ($m)	**54.3**	**32.2**	**56.2**	**3%**	**75%**

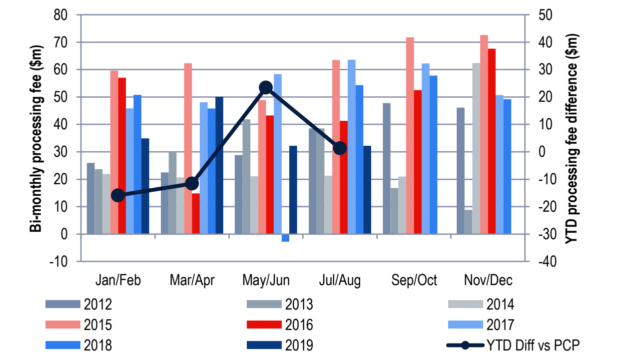
Source: NZR, Forsyth Barr analysis

Figure 2. Historic GRM and uplift over Singapore complex benchmark



Source: NZR, Forsyth Barr analysis

Figure 3. Historic processing fee revenue



Source: NZR, Forsyth Barr analysis

Investment summary

Our rating is NEUTRAL. Refining NZ's (NZR) near-term outlook is looking more positive with shipping fuel specification changes likely to be positive in the coming months. However, we see medium-term uncertainties, particularly demand risk as the global economy slows which may weigh on the GRM.

Business quality

- **Important piece of NZ infrastructure:** NZR produces ~70% of New Zealand's refined fuel requirements and is a core part of the fuel supply infrastructure. In addition, the refinery to Wiri (Auckland) pipeline is a key strategic asset. Auckland is serviced solely from the refinery, which means NZR will always have a future supplying Auckland.
- **NZR margin uplift:** NZR typically receives +US$3 to US$4/barrel more than the Singapore complex margin with freight differentials (it is cheaper to import bulk crude than refined product) and product differentials being the primary drivers.

Earnings and cash flow outlook

- **Significant operating leverage:** NZR is a high fixed cost business meaning changes in the gross refining margin (GRM) and NZDUSD have a significant impact on processing fee revenue and therefore earnings. These two factors are NZR's main value drivers and both are notoriously volatile.
- **Shipping fuel oil changes:** Ships need to switch to low sulphur products from 2020 which could be either positive or negative for NZR, although market expectations are it is likely to be a small positive, kicking in from late 2019.
- **Asia/Pacific refining capacity:** Surplus refining capacity is forecast to fall in the next few years, which should be supportive of refining margins.

Financial structure

- **Moderate financial leverage:** NZR targets debt levels below $200m, however, periods of low earnings and/or high capex can result in higher debt levels. Whilst NZR has some downside protection from a processing fee floor, it limits losses, as opposed to preventing them.

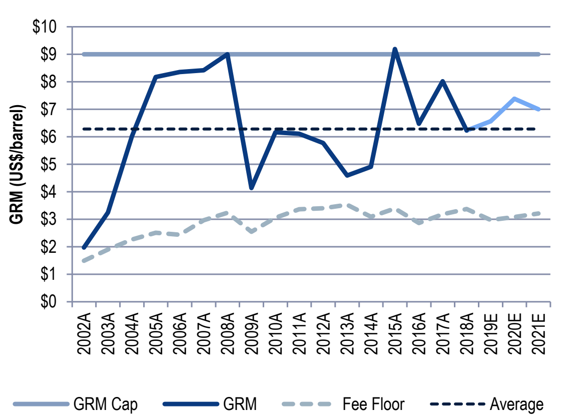
Risk factors

- **Capex outlook:** High operating leverage within NZR mean controlling opex and capex is very important. NZR's guided long-term capex of ~$64m is significantly lower than historic capex levels and if underlying opex/capex were to increase, that would have a material impact on NZR's value.
- **Falling fuel volumes:** A long-term threat to NZR is a fall in fuel demand.

Company description

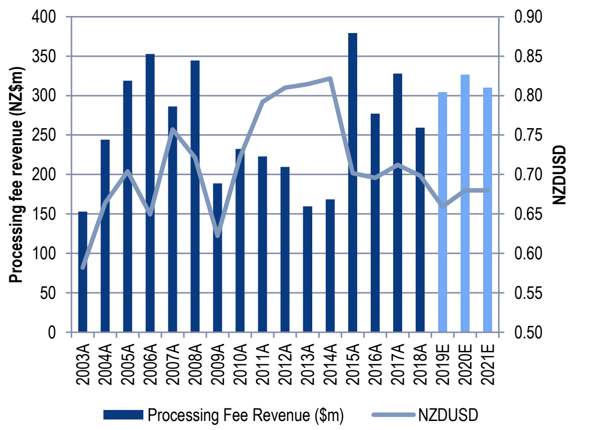
NZR refines crude oil for the NZ market at the Marsden Point Oil Refinery. It produces approximately 60% of NZ's petrol, 65% of diesel and 85% of jet fuel. NZR also owns and operates a pipeline to Wiri, in south Auckland, supplying all of Auckland's refined product. NZR is a tolling operation, receiving a processing fee for refining crude oil. It has a fixed cost base and therefore has high operating leverage to global refining margins and the NZDUSD. NZR's customers are the main three main fuel retailers, Z Energy, BP and Mobil.

Figure 4. Gross refining margin history (GRM)



Source: NZR, Forsyth Barr analysis

Figure 5. Processing fee revenue



Source: NZR, Forsyth Barr analysis

Figure 6. Substantial Shareholders

Shareholder	Latest Holding
Mobil Oil NZ Limited	17.2%
Z Energy Holdings Limited	15.4%
BP	10.1%
Wellington Management Company	8.3%
ACC	5.1%

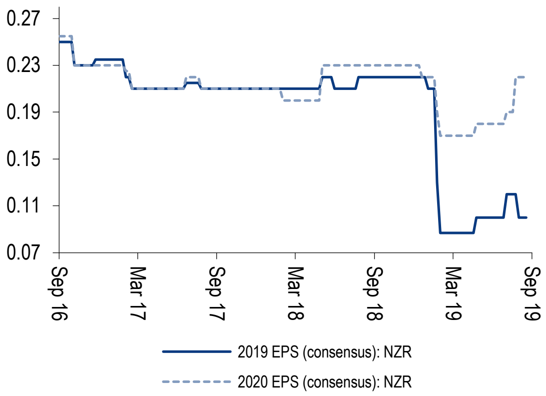
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 7. International Compcos

Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash D/Yld
(metrics re-weighted to reflect NZR's balance date - December)			(m)	2019E	2020E	2019E	2020E	2019E	2020E	2020E
Refining NZ	**NZR NZ**	**NZ$2.10**	**NZ$656**	**15.1x**	**9.8x**	**5.2x**	**4.4x**	**12.6x**	**8.9x**	**5.7%**
Formosa Petrochemical Corp	6505 TT	TWD102.00	TWD971,648	21.6x	17.4x	13.8x	11.2x	17.6x	13.1x	4.4%
Idemitsu Kosan Co	5019 JP	¥3305.00	¥997,864	8.1x	7.0x	7.3x	6.3x	9.8x	n/a	5.3%
Showa Shell Sekiyu KK	5002 JP	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
SK Innovation Co	096770 KS	KRW171500.00	KRW15,857,844	14.1x	9.0x	6.9x	5.4x	10.8x	7.4x	4.7%
S-Oil Corp	010950 KS	KRW101000.00	KRW11,370,862	26.4x	10.2x	12.3x	7.7x	18.8x	9.3x	4.1%
			Compco Average:	**17.5x**	**10.9x**	**10.1x**	**7.6x**	**14.3x**	**9.9x**	**4.6%**
EV = Current Market Cap + Actual Net Debt			**NZR Relative:**	**-14%**	**-11%**	**-49%**	**-42%**	**-12%**	**-10%**	**+23%**

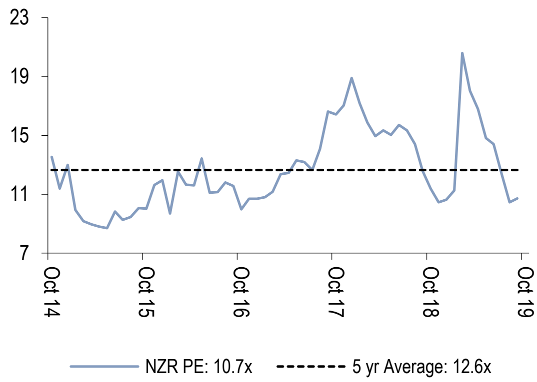
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (NZR) companies fiscal year end

Figure 8. Consensus EPS Momentum



Source: Forsyth Barr analysis, Bloomberg

Figure 9. 12 Month Forward PE



Source: Forsyth Barr analysis