FORSYTH BARR

Spark NZ

OUTPERFORM

Bright Spark in a Low Yield World; Upgrade to OUTPERFORM

Spark (SPK) committed to retaining its dividend, with an expectation it will be fully covered by free cash flow from FY20. In a yield hungry world, we expect SPK's attractive income, robust valuation metrics, impressive track record on execution, and strong balance sheet will find investor appeal. We upgrade to OUTPERFORM.

What's changed?

- **Earnings:** Minor operating earnings changes. Medium-term dividend lifted to NZ25cps.

Continuing to execute

Each year we expect it to get harder, but SPK manages to progress despite the consistent headwind of sharply declining, high margin voice revenues. Again, the leading positive contributors were (1) strong growth in mobile gross margin, up +6%, benefiting from improved subs mix (more postpaid), retail store insourcing, and lower handset subsidies, and (2) labour costs down -7%. Broadband gross margin also expanded, up +9%, from copper price rises and fixed wireless additions. Whilst we expect growth from each of these will be harder in FY20, a -19% reduction in 2H opex (ex. labour) provides a supportive run-rate entering the new year.

A slowdown in the IT Services, but we remain comfortable medium-term

The one factor that fell short of our expectation was the deceleration in IT Services (CCL), with revenue growth dropping to +8% from +17% in the pcp. SPK attributed the slowing to delayed onboarding of new customers, and price pressure on renewals. CCL's black box nature raises the level of consternation for investors (including us). Our recent discussions with industry players raised no significant near-term issues or risks for the business. There is an inherently high margin of error in forecasting CCL, but we maintain the view a healthy growth profile is the most likely outcome over the medium-term.

Dividend supported by lower capex

The principal new information in the result was SPK's commitment to retaining its dividend and its expectation that it will be covered by free cash flow from FY20 supported by (1) lower capex (c.NZ$40m pa) through the medium-term post completion of major IT projects, and (2) a slowing in working capital growth. Dividend sustainability will remain an open question long-term; however, medium-term confidence will be supported by SPK's seemingly adept ability to manage opex and capex to maintain it.

Attractive income in a yield hungry world: upgrade to OUTPERFORM

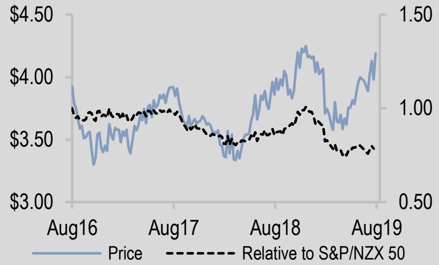
In a world hungry for yield SPK offers an attractive income relative to other defensive NZ stocks, global telco peers, and fixed income. Additionally, valuation metrics are robust, we believe SPK can maintain earnings growth led by mobile, cloud, and cost savings, and the company has a strong track record on execution, consistently outperforming market expectation. SPK's defensive appeal is supported by its strong, A- rated balance sheet.

Investment View

SPK offers an attractive yield vs. peers and bonds, robust valuation metrics, a strong balance sheet, a positive track record on execution, and medium-term growth driven by mobile, cloud and cost savings. OUTPERFORM.

NZX Code	SPK
Share price	NZ$4.19
Target price	NZ$4.55
Risk rating	Medium
Issued shares	1836.2m
Market cap	NZ$7,694m
Average daily turnover	3,900k (NZ$15,214k)

Share Price Performance



Financials: June	19A	20E	21E	22E
NPAT* (NZ$m)	409.0	416.5	420.2	430.6
EPS* (NZc)	22.3	22.7	22.9	23.5
EPS growth* (%)	2.2	1.8	0.9	2.5
DPS (NZc)	25.0	25.0	25.0	25.0
Imputation (%)	75	83	100	100

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	8.1	7.9	8.0	7.9
EV/EBIT	14.3	14.1	14.0	13.8
PE	18.8	18.5	18.3	17.9
Price / NTA	16.1	18.2	23.7	n/a
Cash dividend yield (%)	6.0	6.0	6.0	6.0
Gross dividend yield (%)	7.7	7.9	8.3	8.3

*Historic and forecast numbers based on underlying profits

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Spark NZ Ltd (SPK) — Priced as at 21 Aug 2019: NZ$4.19 — June year end

Forsyth Barr valuation			
Valuation methodology	DCF, sector peer relative, market relative		
12-month target price (NZ$)*	**4.55**	**Spot valuations (NZ$)**	
Expected share price return	8.6%	1. DCF	4.06
Net dividend yield	6.0%	2. Sector peer relative	4.23
Estimated 12-month return	14.6%	3. Market relative	4.89
Key WACC assumptions		**DCF valuation summary (NZ$m)**	
Risk free rate	2.00%	Total firm value	8,620
Equity beta	0.84	(Net debt)/cash	(1,341)
WACC	7.2%	Value of equity	7,279
Terminal growth	1.5%	Shares (m)	1,836

Profit and Loss Account (NZ$m)	2018A	2019A	2020E	2021E	2022E
Sales revenue	3,533	3,533	3,558	3,555	3,585
Normalised EBITDA	**1,030**	**1,090**	**1,115**	**1,112**	**1,120**
Depreciation and amortisation	(481)	(477)	(485)	(480)	(477)
Normalised EBIT	**549**	**613**	**630**	**632**	**643**
Net interest	(42)	(48)	(43)	(39)	(42)
Associate income	47	14	(1)	(1)	4
Tax	(154)	(170)	(170)	(172)	(175)
Minority interests	-	-	-	-	-
Normalised NPAT	**400**	**409**	**416**	**420**	**431**
Abnormals/other	35	-	-	-	-
Reported NPAT	**365**	**409**	**416**	**420**	**431**
Normalised EPS (cps)	21.8	22.3	22.7	22.9	23.5
DPS (cps)	25.0	25.0	25.0	25.0	25.0

Growth Rates	2018A	2019A	2020E	2021E	2022E
Revenue (%)	1.4	0.0	0.7	-0.1	0.9
EBITDA (%)	4.4	5.8	2.3	-0.2	0.7
EBIT (%)	8.7	11.7	2.8	0.3	1.7
Normalised NPAT (%)	6.4	2.3	1.8	0.9	2.5
Normalised EPS (%)	6.2	2.2	1.8	0.9	2.5
DPS (%)	0.0	0.0	13.6	0.0	0.0

Cash Flow (NZ$m)	2018A	2019A	2020E	2021E	2022E
EBITDA	**1,030**	**1,090**	**1,115**	**1,112**	**1,120**
Working capital change	(46)	(122)	(45)	(38)	(43)
Interest & tax paid	(201)	(179)	(209)	(207)	(213)
Other	86	(12)	-	-	5
Operating cash flow	**869**	**777**	**861**	**867**	**869**
Capital expenditure	(422)	(423)	(374)	(503)	(380)
(Acquisitions)/divestments	(42)	1	-	-	-
Other	-	-	-	-	-
Funding available/(required)	**405**	**355**	**487**	**364**	**489**
Dividends paid	(458)	(459)	(459)	(459)	(459)
Equity raised/(returned)	-	-	-	-	-
Increase/(decrease) in net debt	**53**	**104**	**(28)**	**95**	**(30)**

Balance Sheet (NZ$m)	2018A	2019A	2020E	2021E	2022E
Working capital	246	408	453	491	534
Fixed assets	1,039	1,012	932	938	867
Intangibles	956	987	953	965	936
Other assets	409	507	506	505	504
Total funds employed	**2,650**	**2,914**	**2,843**	**2,899**	**2,841**
Net debt/(cash)	1,142	1,341	1,360	1,502	1,519
Other non current liabilities	209	298	298	298	298
Shareholder's funds	1,483	1,465	1,375	1,290	1,214
Minority interests	-	-	-	-	-
Total funding sources	**2,834**	**3,104**	**3,033**	**3,089**	**3,031**

Valuation Ratios	2018A	2019A	2020E	2021E	2022E
EV/EBITDA (x)	8.4	8.1	7.9	8.0	7.9
EV/EBIT (x)	15.7	14.3	14.1	14.0	13.8
PE (x)	19.2	18.8	18.5	18.3	17.9
Price/NTA (x)	14.6	16.1	18.2	23.7	27.7
Free cash flow yield (%)	5.8	4.6	6.3	4.7	6.4
Net dividend yield (%)	5.3	5.3	6.0	6.0	6.0
Gross dividend yield (%)	6.8	6.8	7.9	8.3	8.3
Imputation (%)	75	75	83	100	100
Pay-out ratio (%)	101	99	110	109	107

Capital Structure	2018A	2019A	2020E	2021E	2022E
Interest cover EBIT (x)	13.1	12.8	14.6	16.1	15.3
Interest cover EBITDA (x)	24.5	22.7	25.7	28.3	26.7
Net debt/ND+E (%)	43.5	47.8	49.7	53.8	55.6
Net debt/EBITDA (x)	1.1	1.2	1.2	1.4	1.4

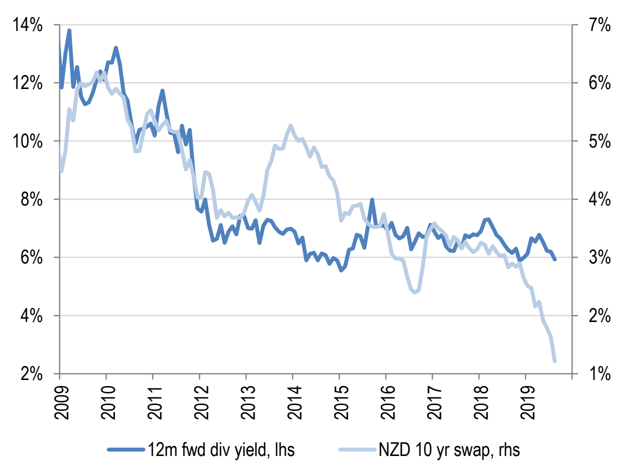
Key Ratios	2018A	2019A	2020E	2021E	2022E
Return on assets (%)	17.2	18.0	18.9	18.6	19.2
Return on equity (%)	27.0	27.9	30.3	32.6	35.5
Return on funds employed (%)	14.3	15.3	15.7	15.8	16.1
EBITDA margin (%)	29.2	30.9	31.3	31.3	31.2
EBIT margin (%)	15.5	17.4	17.7	17.8	17.9
Capex to sales (%)	11.9	12.0	10.5	14.2	10.6
Capex to depreciation (%)	128	132	117	158	120

Operating Performance	2018A	2019A	2020E	2021E	2022E
Revenue (NZ$m)					
Voice	573	486	418	358	304
Broadband	665	685	691	689	692
Managed data	207	197	185	174	164
Mobile	1,237	1,271	1,303	1,326	1,378
IT services	727	765	802	843	876
Other	124	129	158	165	173
Total revenue	**3,533**	**3,533**	**3,558**	**3,555**	**3,585**
Operating expenses (NZ$m)					
Product costs	1,592	1,564	1,598	1,605	1,636
Labour	513	475	464	462	461
Other	398	404	381	375	369
Total operating expenses	**2,503**	**2,443**	**2,443**	**2,442**	**2,465**
Subscribers (000)					
Mobile					
Postpaid	1,189	1,251	1,305	1,356	1,405
Prepaid	1,236	1,232	1,214	1,191	1,167
Total mobile	**2,429**	**2,487**	**2,523**	**2,552**	**2,576**
Broadband					
Copper	346	249	163	111	67
Fibre	238	306	370	403	438
Wireless	116	140	150	162	168
Total	**700**	**695**	**684**	**677**	**674**
ARPU (NZ$/month)					
Postpaid mobile	43.8	42.6	42.2	41.8	42.2
Prepaid mobile	12.2	12.5	12.7	13.0	13.1
Broadband	79.9	84.3	87.0	87.3	87.5

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

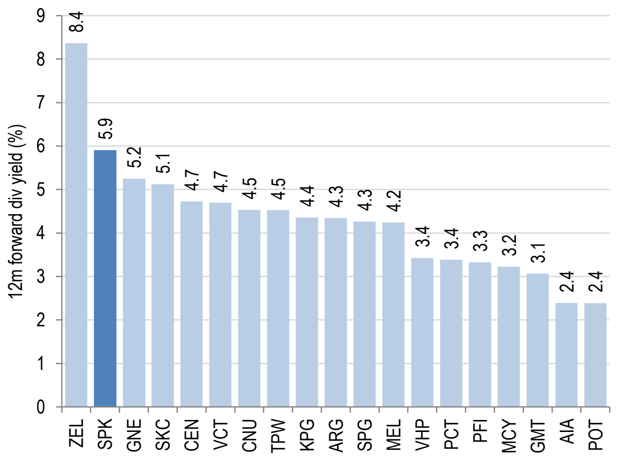
Valuation snapshot

Figure 1. SPK dividend yield vs. NZ 10-year swap



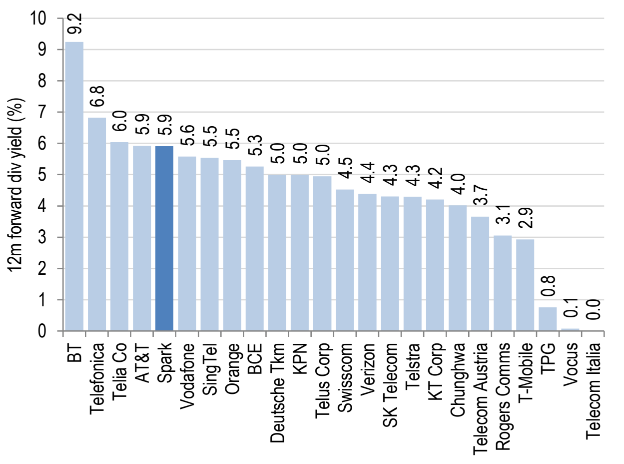
Source: Bloomberg, Forsyth Barr analysis

Figure 2. NZ defensives 12-month forward dividend yield (consensus)



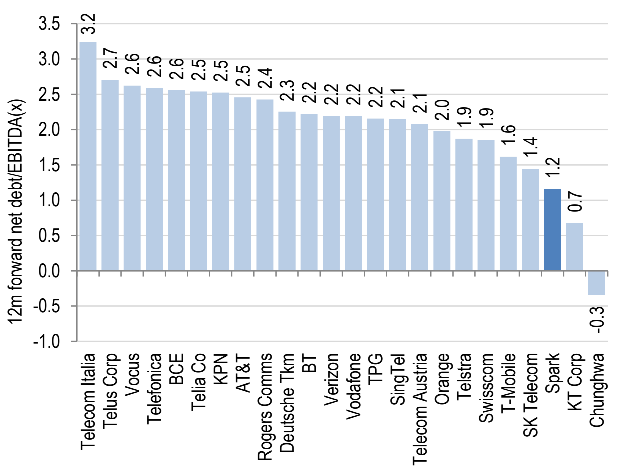
Source: Bloomberg, Forsyth Barr analysis

Figure 3. Telco 12-month forward dividend yield (consensus)



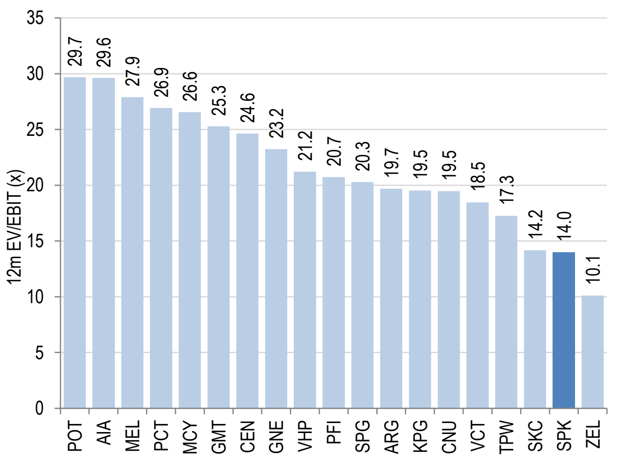
Source: Bloomberg, Forsyth Barr analysis

Figure 4. Telco net debt / EBITDA (consensus)



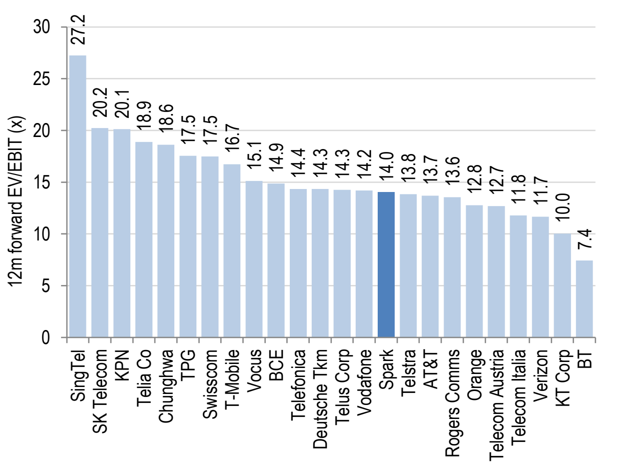
Source: Bloomberg, Forsyth Barr analysis

Figure 5. NZ defensives 12-month forward EV/EBIT (consensus)



Source: Bloomberg, Forsyth Barr analysis

Figure 6. Telco 12-month EV/EBIT (consensus)



Source: Bloomberg, Forsyth Barr analysis

Result analysis

Figure 7. FY19 result analysis

NZ$m	FY18	FY19	% chg	Forbar	% diff	
Revenue						
Fixed						
Voice	573	486	-15.2%	484	0.4%	Connections -11%, including Vodafone transitioning off the PSTN, and shifts to naked plans. Continued decline in calling minutes.
Broadband	665	685	3.0%	695	-1.4%	Copper price increase, offsetting connections down -1%.
Managed data	207	197	-4.8%	191	2.9%	
Total fixed	**1,445**	**1,368**	**-5.3%**	**1,370**	**-0.2%**	
Mobile	1,237	1,271	2.7%	1,260	0.8%	Total/postpaid connections +2%/+5%. Total ARPU +1% with consumer growth offset by business decline.
Cloud, security and service mgmt	370	400	8.1%	411	-2.6%	Below +10% target due to price pressure on customer renewals and delays in onboarding two large customers.
Procurement and partners	357	365	2.2%	371	-1.5%	
Other	114	114	0.0%	117	-2.8%	
Other gains	10	15	50.0%	0	nm	Sale of legacy network equipment, other divestments.
Total revenue	**3,523**	**3,518**	**-0.1%**	**3,529**	**-0.3%**	
Gross margin						
Fixed						
Voice	369	310	-16.0%	304	2.0%	Decline on the back of connection losses.
Broadband	315	344	9.2%	338	1.9%	NZ$14m access cost savings from increased fixed wireless uptake + benefit of copper price increases.
Managed data	111	104	-6.3%	105	-1.2%	Migration off legacy to lower priced fibre products.
Total fixed	**795**	**758**	**-4.7%**	**747**	**1.5%**	
Mobile	732	775	5.9%	773	0.2%	Growth in higher margin service revenue, reduced sales costs from retail store insourcing, fewer subsidised plans.
Cloud, security and service mgmt	315	327	3.8%	346	-5.4%	Impacted by price pressure on renewals, and a higher weighting of lower margin service management revenue.
Procurement and partners	40	43	7.5%	42	1.8%	
Other	49	51	4.1%	47	7.6%	
Other gains	10	15	50.0%	0	nm	
Total gross margin	**1,941**	**1,969**	**1.4%**	**1,955**	**0.7%**	
Operating expenses						
Labour	(513)	(475)	-7.4%	(473)	0.4%	Full year benefit of Quantum labour savings. FTEs -4%.
Restructuring costs	(49)	0	nm	0	nm	One-off Quantum implementation costs in the pcp.
Other	(398)	(404)	1.5%	(416)	-2.9%	Higher electricity spot prices.
Total operating expenses	**(960)**	**(879)**	**-8.4%**	**(889)**	**-1.1%**	
EBITDA	**981**	**1,090**	**11.1%**	**1,066**	**2.2%**	
Depreciation & amortisation	(481)	(477)	-0.8%	(483)	-1.2%	
EBIT	**500**	**613**	**22.6%**	**584**	**5.0%**	
Interest	(42)	(48)	14.3%	(44)	8.1%	
Net profit before tax	**458**	**565**	**23.4%**	**539**	**4.7%**	
Tax	(140)	(170)	21.4%	(160)	6.3%	
Associates/JV losses	47	14	-70.2%	15	-6.7%	Southern Cross dividend lowered from NZ$50m to NZ$15m.
Reported NPAT	**365**	**409**	**12.1%**	**379**	**7.8%**	
Underlying profit	**400**	**409**	**2.3%**	**394**	**3.7%**	
Underlying EPS (cps)	21.8	22.3	2.2%	21.5	3.7%	
Dividend (cps)	25.0	25.0	0.0%	25.0	0.0%	75% imputed for NZ investors.

Source: Company reports, Forsyth Barr analysis

Earnings revisions

Minor operating changes, including lower opex. The suspension of the Southern Cross dividend (to offset capex) in FY20/21 impacts reported NPAT. Dividend lifted to NZ25cps.

Figure 8. Earnings revisions

		FY20E			FY21E		FY22E
NZ$m	**Old**	**New**	**% chg**	**Old**	**New**	**% chg**	**New**
Revenue	3,573	3,558	-0.4%	3,598	3,555	-1.2%	3,585
EBITDA	1,084	1,115	2.9%	1,089	1,112	2.2%	1,120
EBIT	609	630	3.6%	622	632	1.7%	643
Underlying profit	415	416	0.4%	428	420	-1.7%	431
Underlying EPS (cps)	22.6	22.7	0.3%	23.3	22.9	-1.8%	23.5
Dividend (cps)	22.0	25.0	13.6%	22.0	25.0	13.6%	25.0

Source: Forsyth Barr analysis

Investment summary

In a world hungry for yield SPK offers an attractive income relative to other defensive NZ stocks, global telco peers, and fixed income. Valuation metrics are robust, we believe SPK can maintain earnings growth led by mobile, cloud, and cost savings, and the company has a strong track record on execution, consistently outperforming market expectation. SPK's defensive appeal is supported by its strong, A- rated balance sheet. OUTPERFORM.

Business quality

- **Legacy challenges:** As the incumbent, SPK still has a significant exposure to declining voice and managed data. Additionally, NZ's industry structure with a separate wholesale network operator (Chorus), and standardised network input costs fuels intense broadband competition (>80 competitors).
- **Effective strategic/management pivot:** Despite these challenges, SPK has pivoted its focus to mobile and cloud which now represent c.56% of gross margin. NZ's three-player mobile market continues to successfully balance return with customer price and service. SPK's investment in IT services has enabled it to benefit from companies' rapid migration to the cloud, escalating focus on cyber security, and growth in IT outsourcing.

Earnings and cash flow outlook

- **Track record of successful execution:** We expect SPK will likely continue to deliver modest medium-term EPS with mobile and IT Services revenue, and cost savings offsetting legacy product declines. From FY20 cash flow will be boosted by (1) lower capex (c.NZ$40m pa) through the medium-term post completion of major IT projects, and (2) a slowing in working capital growth.

Financial structure

- **Gearing:** SPK has a strong balance sheet with a policy to maintain net debt/EBITDA <1.4x (1.2x at FY19 year-end), and A- S&P credit rating.

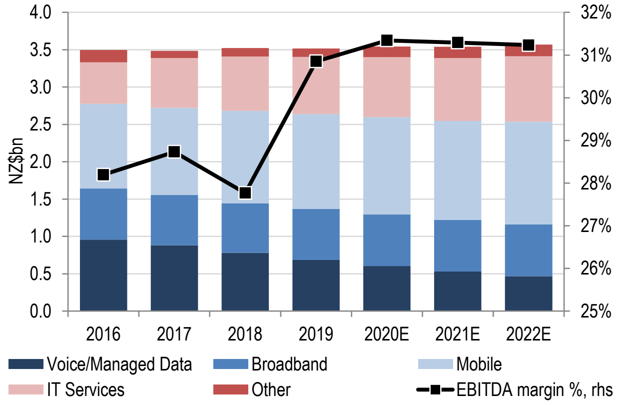
Risks factors

- **Delivery of cost savings:** It is difficult to have insight into deliverability; however, we take comfort from SPK's investment in simplifying/digitalising systems, processes, and products, and its execution track record.
- **Competitive pressures or slowing growth in mobile and IT services.**
- **Rising interest rates:** SPK is largely owned by income-seeking investors.

Company description

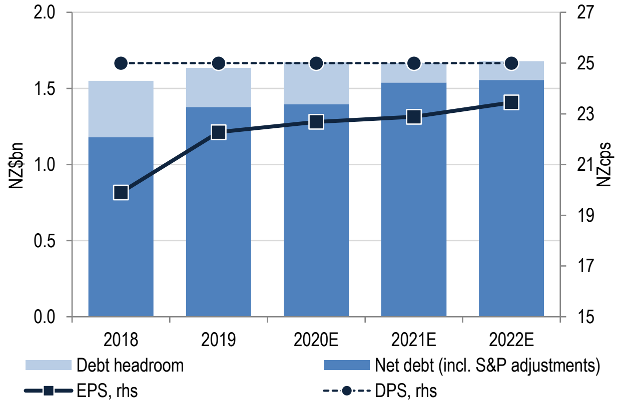
SPK is NZ's largest provider of fixed-line telco services (c.58% market share), a major player in mobile (c.40% market share) and IT services and owns 50% of (the principally submarine) Southern Cross Cables Network. SPK does not own a fixed-line network; its legacy network was spun off through its demerger from Chorus in 2011.

Figure 9. SPK revenue and EBITDA margin



Source: Company reports, Forsyth Barr analysis

Figure 10. SPK EPS, DPS and debt



Source: Company reports, Forsyth Barr analysis

Figure 11. Substantial Shareholders

Shareholder	Latest Holding
BlackRock Investment Management	7.5%
The Vanguard Group	5.2%

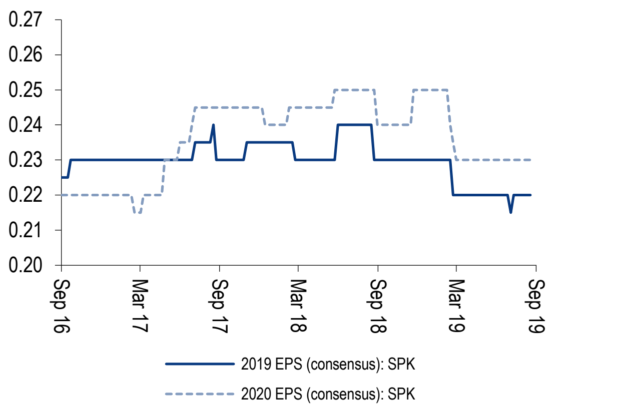
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 12. International Compcos

Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash D/Yld
(metrics re-weighted to reflect SPK's balance date - June)			(m)	2020E	2021E	2020E	2021E	2020E	2021E	2021E
Spark NZ	**SPK NZ**	**NZ$4.19**	**NZ$7,694**	**18.5x**	**18.3x**	**8.1x**	**8.1x**	**14.3x**	**14.3x**	**6.0%**
Telstra Corp	TLS AT	A$3.78	A$44,957	17.6x	18.9x	6.9x	7.2x	13.8x	15.3x	4.3%
Singapore Telecommunications	ST SP	S$3.22	S$52,580	17.1x	15.7x	13.4x	12.8x	27.5x	27.0x	5.4%
BT Group PLC	BT/A LN	£1.63	£16,092	6.6x	6.5x	3.6x	3.5x	7.4x	7.3x	8.9%
Vodafone Group PLC	VOD LN	€1.63	€39,685	19.6x	15.6x	4.6x	4.4x	13.5x	11.9x	5.5%
Orange SA	ORA FP	€13.50	€35,911	12.5x	11.6x	5.1x	5.0x	11.4x	10.9x	5.7%
Deutsche Telekom AG	DTE GR	€14.94	€71,155	14.1x	12.7x	5.6x	5.3x	13.3x	12.2x	5.3%
Swisscom AG	SCMN SW	CHF486.70	CHF25,212	16.9x	17.0x	7.9x	7.8x	16.9x	17.1x	4.6%
Verizon Communications Inc	VZ US	US$56.50	US$233,567	11.7x	11.4x	7.5x	7.4x	11.7x	11.4x	4.4%
AT&T Inc	T US	US$35.11	US$256,512	9.7x	9.7x	7.4x	7.4x	13.7x	13.0x	6.0%
BCE Inc	BCE CN	C$61.87	C$55,688	17.1x	16.2x	8.1x	7.8x	14.3x	13.9x	5.4%
TPG Telecom	TPM AT	A$6.62	A$6,142	21.9x	27.2x	10.0x	10.5x	17.2x	21.7x	0.9%
			Compco Average:	**15.0x**	**14.8x**	**7.3x**	**7.2x**	**14.6x**	**14.7x**	**5.1%**
EV = Current Market Cap + Actual Net Debt			**SPK Relative:**	**+23%**	**+24%**	**+11%**	**+13%**	**-2%**	**-3%**	**+17%**

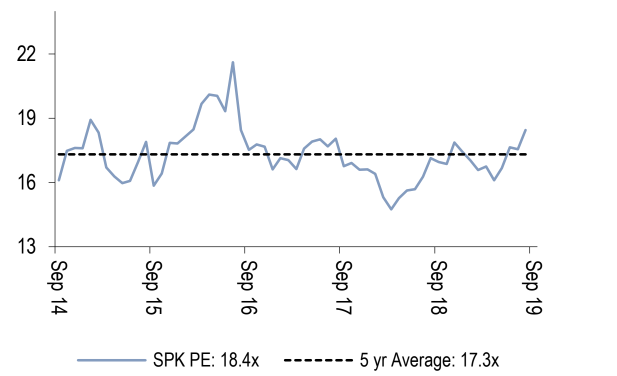
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (SPK) companies fiscal year end

Figure 13. Consensus EPS Momentum



Source: Forsyth Barr analysis, Bloomberg

Figure 14. 12 Month Forward PE



Source: Forsyth Barr analysis