NEW ZEALAND EQUITY RESEARCH | TELECOMMUNICATIONS | FIXED, MOBILE, IT
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Spark NZ
1H20 Preview — Steady Performer

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OUTPERFORM

Spark (SPK) reports its 1H20 result on 19 February — there should be no material surprises after November's reiteration of guidance. We are forecasting a +3.7% lift in EBITDA, and expect no material change in key operating trends — growth in mobile and cloud/security, plus labour savings, to outpace the ongoing decline in legacy voice. Any insight into the net cost of the Rugby World Cup, and Spark Sport economics will be of interest.

NZX Code	SPK
Share price	NZ$4.76
Target price	NZ$4.55
Risk rating	Medium
Issued shares	1836.2m
Market cap	NZ$8,749m
Avg daily turnover	3,456k (NZ$13,920k)

Financials: Jun/	19A	20E	21E	22E
NPAT* (NZ$m)	409.0	413.6	414.9	423.9
EPS* (NZc)	22.3	22.5	22.6	23.1
EPS growth* (%)	2.2	1.1	0.3	2.2
DPS (NZc)	25.0	25.0	25.0	25.0
Imputation (%)	75	83	99	100
*Based on normalised profits				

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	9.0	8.9	8.9	8.9
EV/EBIT	16.1	15.8	15.8	15.6
PE	21.4	21.2	21.1	20.6
Price / NTA	18.3	18.5	20.7	20.7
Cash div yld (%)	5.2	5.2	5.2	5.2
Gross div yld (%)	6.8	6.9	7.3	7.3

Key issues to watch for

- **Modest earnings growth:** We expect EBITDA growth through: (1) mobile (prepaid to postpaid transition, prepaid data growth, customers trading up to higher tier plans, lower handset subsidies) and IT services growth, and (2) labour cost reductions (with sharp reductions in 2H19 providing a strong run-rate entering FY20), offsetting (3) continued declines in high-margin legacy voice and managed data. Given stable competition and pricing in both mobile and fixed line, we see limited scope for material surprises in these businesses.
- **A look inside the IT Services black box is always of interest:** Insight into SPK's IT services business CCL is always helpful given the contrasting pressures of growth in cloud migration, cyber security and IT outsourcing vs. price pressures from commoditisation/ competition. There is an inherently higher margin of error in any CCL forecast — SPK has guided to FY20 revenue up +8–10%.
- **Any insight into SPK's media commitments:** We're interested in any insight into (1) the net cost of Spark Sport through the Rugby World Cup, (2) the ongoing economics of Spark Sport including SPK's acquisition of NZ Cricket rights from next summer, and (3) SPK's ongoing commitment to Lightbox following its sale to Sky TV.

Investor briefing

Conference call: 10:00am (NZ time), NZ 083035, AU 1800 007 094, USA 1800 6518 618. Passcode: 3366408.

Figure 1. SPK 1H20E forecasts

NZ$m	1H19	1H20E	% chg
Revenue	1,754	1,789	2.0%
EBITDA	489	507	3.7%
EBIT	244	264	8.1%
Underlying profit	153	172	12.4%
Underlying EPS (cps)	8.3	9.4	12.3%
Dividend (cps)	12.5	12.5	0.0%

Source: Forsyth Barr analysis

FORSYTH BARR

Spark NZ Ltd (SPK)

Priced as at 17 Feb 2020 (NZ$)	4.77

12-month target price (NZ$)*	4.55
Expected share price return	-4.6%
Net dividend yield	5.2%
Estimated 12-month return	0.6%

Spot valuations (NZ$)	
1. DCF	4.01
2. Sector peer relative	3.77
3. Market relative	4.42

Key WACC assumptions	
Risk free rate	2.00%
Equity beta	0.84
WACC	7.2%
Terminal growth	1.5%

DCF valuation summary (NZ$m)	
Total firm value	9,223
(Net debt)/cash	(1,341)
Less: Capitalised operating leases	(521)
Value of equity	7,361

Profit and Loss Account (NZ$m)	2018A	2019A	2020E	2021E	2022E
Sales revenue	3,533.0	3,533.0	3,557.7	3,554.7	3,585.1
Normalised EBITDA	**1,030.0**	**1,090.0**	**1,115.1**	**1,112.4**	**1,119.8**
Depreciation and amortisation	(481.0)	(477.0)	(486.2)	(485.1)	(483.9)
Normalised EBIT	**549.0**	**613.0**	**628.9**	**627.3**	**635.9**
Net interest	(42.0)	(48.0)	(45.9)	(41.6)	(44.1)
Associate income	47.0	14.0	(1.0)	(1.0)	4.0
Tax	(154.0)	(170.0)	(168.5)	(169.9)	(171.9)
Minority interests	0	0	0	0	0
Normalised NPAT	**400.0**	**409.0**	**413.6**	**414.9**	**423.9**
Abnormals/other	(35.0)	0	0	0	0
Reported NPAT	**365.0**	**409.0**	**413.6**	**414.9**	**423.9**
Normalised EPS (cps)	21.8	22.3	22.5	22.6	23.1
DPS (cps)	25.0	25.0	25.0	25.0	25.0

Valuation Ratios	2018A	2019A	2020E	2021E	2022E
EV/EBITDA (x)	9.4	9.0	8.9	8.9	8.9
EV/EBIT (x)	17.7	16.1	15.8	15.9	15.6
PE (x)	21.9	21.4	21.2	21.1	20.7
Price/NTA (x)	16.6	18.3	18.5	20.7	20.7
Free cash flow yield (%)	5.1	4.0	5.5	4.1	5.5
Net dividend yield (%)	5.2	5.2	5.2	5.2	5.2
Gross dividend yield (%)	6.8	6.8	6.9	7.3	7.3

Capital Structure	2018A	2019A	2020E	2021E	2022E
Interest cover EBIT (x)	13.1	12.8	13.7	15.1	14.4
Interest cover EBITDA (x)	24.5	22.7	24.3	26.8	25.4
Net debt/ND+E (%)	43.5	47.8	49.0	52.2	53.1
Net debt/EBITDA (x)	1.1	1.2	1.2	1.4	1.4

Growth Rates	2018A	2019A	2020A	2021A	2022A
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	2.6	-0.3	1.4
Normalised NPAT (%)	6.7	2.3	1.1	0.3	2.2
Normalised EPS (%)	6.5	2.2	1.1	0.3	2.2
Ordinary DPS (%)	0.0	0.0	13.6	0.0	0.0

Key Ratios	2018A	2019A	2020E	2021E	2022E
Return on assets (%)	14.3	15.0	15.3	14.8	14.9
Return on equity (%)	27.0	27.9	29.0	29.9	31.2
Return on funds employed (%)	14.3	15.3	15.5	15.2	15.1
EBITDA margin (%)	29.2	30.9	31.3	31.3	31.2
EBIT margin (%)	15.5	17.4	17.7	17.6	17.7
Capex to sales (%)	11.9	12.0	10.5	14.1	10.6
Capex to depreciation (%)	128	132	116	156	118
Imputation (%)	75	75	83	99	100
Pay-out ratio (%)	115	112	111	111	108

Cash Flow (NZ$m)	2018A	2019A	2020E	2021E	2022E
EBITDA	**1,030.0**	**1,090.0**	**1,115.1**	**1,112.4**	**1,119.8**
Working capital change	(46.0)	(122.0)	(45.0)	(38.3)	(43.1)
Interest & tax paid	(201.0)	(179.0)	(214.3)	(211.4)	(216.0)
Other	86.0	(12.0)	0	0	5.0
Operating cash flow	**869.0**	**777.0**	**855.7**	**862.7**	**865.7**
Capital expenditure	(422.0)	(423.0)	(373.9)	(502.8)	(380.0)
(Acquisitions)/divestments	(42.0)	1.0	0	0	0
Other	(47.0)	(47.0)	(48.9)	(49.2)	(50.4)
Funding available/(required)	**358.0**	**308.0**	**432.8**	**310.6**	**435.2**
Dividends paid	(458.0)	(459.0)	(459.0)	(459.0)	(459.0)
Equity raised/(returned)	0	0	0	0	0
(Increase)/decrease in net debt	**(100.0)**	**(151.0)**	**(26.2)**	**(148.4)**	**(23.8)**

Operating Performance	2018A	2019A	2020E	2021E	2022E
Gross margin (NZ$m)					
Voice	369.0	310.0	257.1	212.8	173.0
Broadband	315.0	344.0	352.9	354.8	355.5
Managed data and networks	111.0	104.0	96.3	88.8	81.8
Mobile	732.0	775.0	797.8	814.2	842.6
IT services	355.0	370.0	389.6	410.2	424.7
Other	59.0	66.0	66.2	68.7	71.4
Total gross margin	**1,941.0**	**1,969.0**	**1,959.8**	**1,949.6**	**1,949.1**
Operating expenses (NZ$m)					
Labour	513.0	475.0	463.8	462.4	460.6
Other	398.0	404.0	381.0	374.7	368.7
Total operating expenses	**911.0**	**879.0**	**844.8**	**837.2**	**829.2**
Subscribers (000)					
Postpaid mobile	1,189.0	1,251.0	1,305.3	1,356.1	1,405.2
Prepaid mobile	1,236.0	1,232.0	1,213.9	1,191.5	1,166.5
Broadband	700.0	695.0	683.9	677.1	674.0
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

Balance Sheet (NZ$m)	2018A	2019A	2020E	2021E	2022E
Working capital	246.0	408.0	453.0	491.3	534.4
Fixed assets	1,039.0	1,012.0	1,013.5	1,099.0	1,104.9
Intangibles	956.0	987.0	952.6	965.0	936.1
Right of use asset	658.0	680.0	683.2	686.5	689.9
Other assets	409.0	507.0	506.0	505.0	504.0
Total funds employed	**3,308.0**	**3,594.0**	**3,608.4**	**3,746.8**	**3,769.2**
Net debt/(cash)	1,142.0	1,341.0	1,367.2	1,515.6	1,539.4
Lease liability	474.0	490.0	520.6	549.7	577.4
Other liabilities	209.0	298.0	295.1	294.1	294.1
Shareholder's funds	1,483.0	1,465.0	1,425.6	1,387.4	1,358.3
Minority interests	0	0	0	0	0
Total funding sources	**3,308.0**	**3,594.0**	**3,608.4**	**3,746.8**	**3,769.2**

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

Earnings forecasts

Figure 2. 1H20E earnings forecasts

NZ$m	1H19	1H20E	% chg
Revenue			
Fixed			
Voice	250	215	-14.0%
Broadband	344	344	0.1%
Managed data	96	93	-3.6%
Total fixed	690	652	-5.5%
Mobile	622	647	4.0%
Cloud, security and service mgmt	195	211	8.0%
Procurement and partners	191	190	-0.4%
Other	56	90	60.3%
Other gains	0	0	n.a.
Total revenue	1,754	1,789	2.0%
Gross margin			
Fixed			
Voice	158	131	-17.1%
Broadband	168	172	2.6%
Managed data	51	47	-7.4%
Total fixed	377	351	-7.0%
Mobile	376	387	2.9%
Cloud, security and service mgmt	163	168	3.0%
Procurement and partners	18	18	-0.2%
Other	25	20	-18.8%
Other gains	0	0	n.a.
Total gross margin	959	944	-1.6%
Operating expenses			
Labour	(250)	(243)	-2.9%
Restructuring costs	0	0	n.a.
Other	(220)	(194)	-11.7%
Total operating expenses	(470)	(437)	-7.0%
EBITDA	489	507	3.7%
Depreciation & amortisation	(245)	(243)	-0.8%
EBIT	244	264	8.1%
Interest	(22)	(22)	0.1%
Net profit before tax	222	242	8.9%
Tax	(69)	(70)	1.3%
Equity accounted earnings	0	0	n.a.
Reported NPAT	153	172	12.4%
Underlying profit	153	172	12.4%
Underlying EPS (cps)	8.3	9.4	12.3%
Dividend (cps)	12.5	12.5	0.0%

Source: Company reports, 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 expectations. 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 cashflow 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.

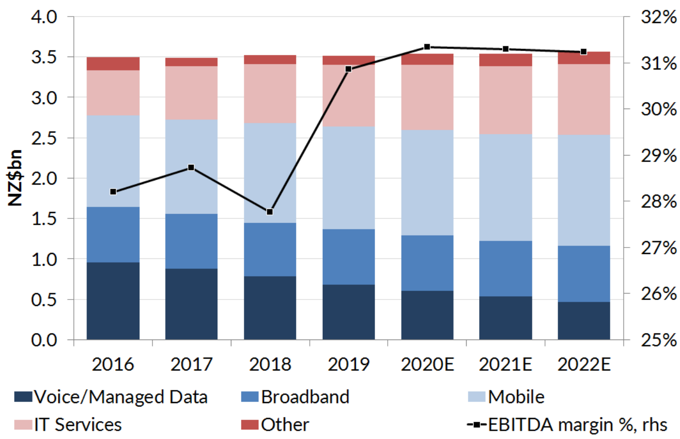
Financial structure

- **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.

Risk factors

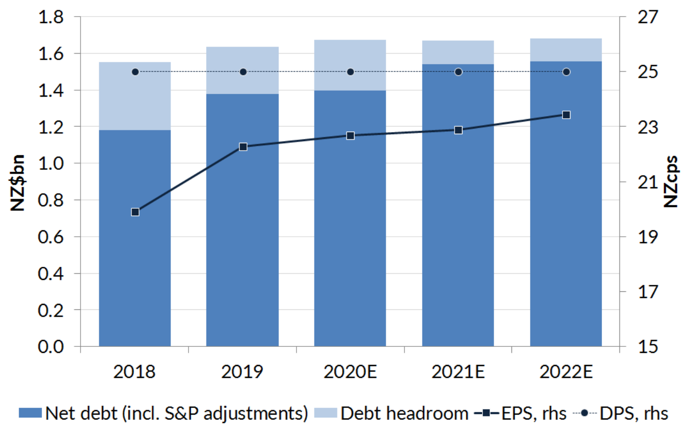
- **Delivery of cost savings:** It is difficult to have insight into deliverability; however, we take comfort from SPK's investment in simplifying/digitalising systems, processes, and products, and its execution track record.
- **Competitive pressures or slowing growth in mobile and IT services.**
-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

Figure 3. SPK revenue and EBITDA margin



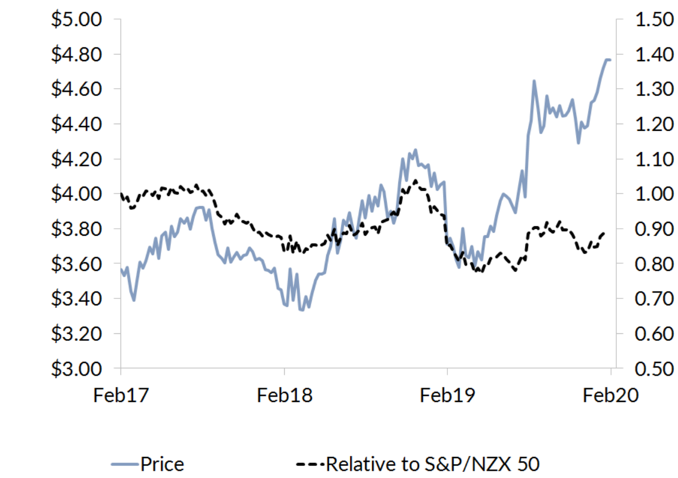
Source: Company reports, Forsyth Barr analysis

Figure 4. SPK EPS, DPS and debt



Source: Company reports, Forsyth Barr analysis

Figure 5. Price performance



Source: Forsyth Barr analysis

Figure 6. Substantial shareholders

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

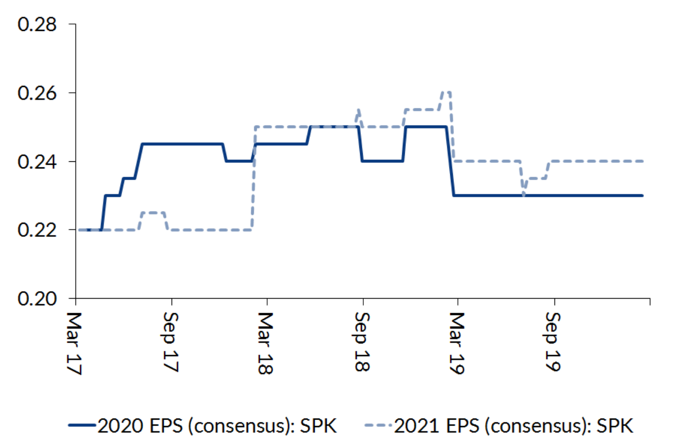
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 7. International valuation comparisons

Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash Yld
(metrics re-weighted to reflect SPK's balance date - June)			(m)	2020E	2021E	2020E	2021E	2020E	2021E	2021E
Spark NZ	**SPK NZ**	**NZ$4.77**	**NZ$8,749**	**21.2x**	**21.1x**	**9.0x**	**9.1x**	**16.0x**	**16.1x**	**5.2%**
Telstra Corp	TLS AT	A$3.72	A$44,243	18.5x	18.8x	7.1x	7.4x	15.5x	15.8x	4.3%
Singapore Telecommunications	ST SP	S$3.21	S$52,415	18.9x	16.9x	14.1x	14.2x	29.5x	28.4x	5.3%
BT Group PLC	BT/A LN	£1.54	£15,193	6.6x	6.5x	4.4x	4.4x	9.5x	9.4x	7.4%
Vodafone Group PLC	VOD LN	€1.82	€40,457	21.3x	16.4x	6.6x	6.4x	19.7x	17.4x	5.2%
Orange SA	ORA FP	€13.39	€35,605	12.8x	12.2x	4.8x	4.9x	11.2x	11.2x	5.6%
Deutsche Telekom AG	DTE GR	€15.68	€74,650	15.1x	13.6x	6.0x	5.7x	14.2x	12.7x	4.4%
Swisscom AG	SCMN SW	CHF572.40	CHF29,651	18.8x	19.8x	8.9x	8.9x	19.8x	19.6x	3.9%
Verizon Communications Inc	VZ US	US$58.51	US$241,997	12.2x	11.6x	7.8x	7.6x	12.0x	11.6x	4.2%
AT&T Inc	T US	US$38.25	US$277,504	15.4x	10.3x	7.8x	7.5x	15.2x	13.8x	5.5%
BCE Inc	BCE CN	C$64.33	C$58,148	18.5x	17.5x	8.3x	8.0x	15.0x	14.7x	5.3%
TPG Telecom	TPM AT	A$8.04	A$7,460	29.9x	29.9x	12.2x	12.1x	21.4x	23.4x	0.7%
			Compco Average:	**17.1x**	**15.8x**	**8.0x**	**7.9x**	**16.6x**	**16.2x**	**4.7%**
EV = Current Market Cap + Actual Net Debt			**SPK Relative:**	**24%**	**34%**	**13%**	**15%**	**-4%**	**-1%**	**11%**

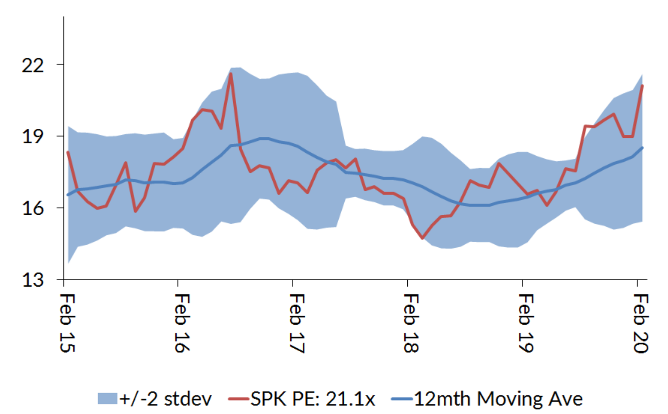
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (SPK) companies fiscal year end

Figure 8. Consensus EPS momentum (NZ$)



Source: Forsyth Barr analysis

Figure 9. One year forward PE (x)



Source: Forsyth Barr analysis

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