

# Spark NZ

## 1H20 – Steady and Reliable

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### OUTPERFORM

Spark (SPK) delivered another very sound performance. Operating trends remain broadly consistent, and there was not any material new information in the result. Positive growth in mobile revenue underpins SPK's strong position in a healthy and rational market. A robust performance from CCL, SPK's IT services/cloud business, is reassuring after slower growth in 2H19. And the headwind from the decline in legacy voice is moderating as its base declines. In a world hungry for yield, we expect investors will continue see appeal in SPK's consistent delivery, solid market positions, A- rated balance sheet, and attractive dividend yield. Maintain OUTPERFORM.

NZX Code	SPK	Financials: Jun/	19A	20E	21E	22E	Valuation (x)	19A	20E	21E	22E
Share price	NZ\$4.78	NPAT* (NZ\$m)	409.0	402.9	417.5	430.7	EV/EBITDA	9.1	9.0	8.9	8.8
Target price	NZ\$4.80	EPS* (NZc)	22.3	21.9	22.7	23.5	EV/EBIT	16.1	15.8	15.5	15.1
Risk rating	Medium	EPS growth* (%)	2.2	-1.5	3.6	3.2	PE	21.5	21.8	21.0	20.4
Issued shares	1836.2m	DPS (NZc)	25.0	25.0	25.0	25.0	Price / NTA	18.4	19.7	23.1	23.7
Market cap	NZ\$8,777m	Imputation (%)	75	82	99	100	Cash div yld (%)	5.2	5.2	5.2	5.2
Avg daily turnover	3,448k (NZ\$13,895k)	*Based on normalised profits					Gross div yld (%)	6.8	6.9	7.3	7.3

### Business as usual

SPK delivered a solid +2% lift in EBITDA, which, coupled with lower depreciation and amortisation, leveraged through to a +9% lift in NPAT. The main features of the period were:

1. Strong growth in mobile gross margin (GM), up +8%/+NZ\$29m benefiting from prepaid to postpaid transition, and customers trading up to higher tier plans; offsetting:
2. Continued declines in legacy voice, GM down -13%/-NZ\$19m. The headwind has moderated (1) following Vodafone's migration off SPK's PSTN, and (2) the lower base effect – voice now represents 12% of SPK's total GM vs. 22% only 3 years ago.
3. A -NZ\$10m reduction in "other" GM which includes (we presume a loss) from Spark Sport and other new ventures.
4. An underlying reduction in labour costs, but a headline uplift of +NZ\$17m, including (1) -NZ\$21m less labour capitalised (consistent with SPK's previous guidance of a drop in capex), and (2) a c.+NZ\$10m increase in Cloud staff costs.

Elsewhere the business's performance was broadly stable. Broadband GM expanded +4%/+NZ\$7m from copper price increases and fixed wireless additions through FY19, despite connections easing. Cloud *et al* revenue grew +12%, although the associated costs (largely labour), means the lift in contribution margin is a modest +NZ\$3m. Free cash flow (FCF) was muted in the period by capex phasing and timing of tax payments. SPK expects normalisation of FCF and net debt to decline in the 2H.

### Steady and reliable is good

SPK maintained guidance of modest EBITDA growth to NZ\$1,100–1,120m, and a flat dividend. We have made no material change to earnings forecasts.

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.

**Spark NZ Ltd (SPK)**

 Priced as at 19 Feb 2020 (NZ\$) **4.78**

<b>12-month target price (NZ\$)*</b>	<b>4.80</b>
Expected share price return	0.4%
Net dividend yield	5.2%
Estimated 12-month return	5.6%

<b>Key WACC assumptions</b>	
Risk free rate	2.00%
Equity beta	0.84
WACC	7.2%
Terminal growth	1.5%

<b>Spot valuations (NZ\$)</b>	
1. DCF	3.97
2. Sector peer relative	4.07
3. Market relative	4.59

<b>DCF valuation summary (NZ\$m)</b>	
Total firm value	9,158
(Net debt)/cash	(1,341)
Less: Capitalised operating leases	(521)
Value of equity	7,296

<b>Profit and Loss Account (NZ\$m)</b>	2018A	2019A	2020E	2021E	2022E
Sales revenue	3,533.0	3,533.0	3,621.4	3,639.7	3,685.2
<b>Normalised EBITDA</b>	<b>1,030.0</b>	<b>1,090.0</b>	<b>1,102.6</b>	<b>1,116.8</b>	<b>1,136.0</b>
Depreciation and amortisation	(481.0)	(477.0)	(473.8)	(473.0)	(474.1)
<b>Normalised EBIT</b>	<b>549.0</b>	<b>613.0</b>	<b>628.8</b>	<b>643.7</b>	<b>661.9</b>
Net interest	(42.0)	(48.0)	(57.0)	(54.3)	(60.4)
Associate income	47.0	14.0	(1.0)	(1.0)	4.0
Tax	(154.0)	(170.0)	(167.9)	(170.9)	(174.8)
Minority interests	0	0	0	0	0
<b>Normalised NPAT</b>	<b>400.0</b>	<b>409.0</b>	<b>402.9</b>	<b>417.5</b>	<b>430.7</b>
Abnormals/other	(35.0)	0	0	0	0
<b>Reported NPAT</b>	<b>365.0</b>	<b>409.0</b>	<b>402.9</b>	<b>417.5</b>	<b>430.7</b>
Normalised EPS (cps)	21.8	22.3	21.9	22.7	23.5
DPS (cps)	25.0	25.0	25.0	25.0	25.0

<b>Valuation Ratios</b>	2018A	2019A	2020E	2021E	2022E
EV/EBITDA (x)	9.4	9.1	9.0	8.9	8.8
EV/EBIT (x)	17.7	16.1	15.8	15.5	15.1
PE (x)	21.9	21.5	21.8	21.0	20.4
Price/NTA (x)	16.6	18.4	19.7	23.1	23.7
Free cash flow yield (%)	5.1	4.0	5.2	3.8	5.3
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

<b>Capital Structure</b>	2018A	2019A	2020E	2021E	2022E
Interest cover EBIT (x)	13.1	12.8	11.0	11.8	11.0
Interest cover EBITDA (x)	24.5	22.7	19.3	20.6	18.8
Net debt/ND+E (%)	43.5	47.8	49.4	53.1	54.2
Net debt/EBITDA (x)	1.1	1.2	1.3	1.4	1.4

<b>Growth Rates</b>	2018A	2019A	2020A	2021A	2022A
Revenue (%)	1.4	0.0	2.5	0.5	1.2
EBITDA (%)	4.4	5.8	1.2	1.3	1.7
EBIT (%)	8.7	11.7	2.6	2.4	2.8
Normalised NPAT (%)	6.7	2.3	-1.5	3.6	3.2
Normalised EPS (%)	6.5	2.2	-1.5	3.6	3.2
Ordinary DPS (%)	0.0	0.0	13.6	0.0	0.0

<b>Key Ratios</b>	2018A	2019A	2020E	2021E	2022E
Return on assets (%)	14.3	15.0	15.2	15.0	15.2
Return on equity (%)	27.0	27.9	28.5	30.3	31.7
Return on funds employed (%)	14.3	15.3	15.3	15.4	15.3
EBITDA margin (%)	29.2	30.9	30.4	30.7	30.8
EBIT margin (%)	15.5	17.4	17.4	17.7	18.0
Capex to sales (%)	11.9	12.0	10.4	14.2	10.7
Capex to depreciation (%)	128	132	116	159	121
Imputation (%)	75	75	82	99	100
Pay-out ratio (%)	115	112	114	110	107

<b>Cash Flow (NZ\$m)</b>	2018A	2019A	2020E	2021E	2022E
<b>EBITDA</b>	<b>1,030.0</b>	<b>1,090.0</b>	<b>1,102.6</b>	<b>1,116.8</b>	<b>1,136.0</b>
Working capital change	(46.0)	(122.0)	(47.2)	(43.8)	(47.6)
Interest & tax paid	(201.0)	(179.0)	(225.0)	(225.3)	(235.2)
Other	86.0	(12.0)	0	0	5.0
<b>Operating cash flow</b>	<b>869.0</b>	<b>777.0</b>	<b>830.4</b>	<b>847.7</b>	<b>858.2</b>
Capital expenditure	(422.0)	(423.0)	(378.0)	(516.6)	(394.5)
(Acquisitions)/divestments	(42.0)	1.0	13.0	0	0
Other	(47.0)	(47.0)	(48.9)	(48.6)	(48.2)
<b>Funding available/(required)</b>	<b>358.0</b>	<b>308.0</b>	<b>416.5</b>	<b>282.5</b>	<b>415.5</b>
Dividends paid	(458.0)	(459.0)	(459.0)	(459.0)	(459.0)
Equity raised/(returned)	0	0	0	0	0
<b>(Increase)/decrease in net debt</b>	<b>(100.0)</b>	<b>(151.0)</b>	<b>(42.6)</b>	<b>(176.6)</b>	<b>(43.6)</b>

<b>Operating Performance</b>	2018A	2019A	2020E	2021E	2022E
<b>Gross margin (NZ\$m)</b>					
Voice	339.0	282.0	237.4	206.2	177.9
Broadband	315.0	344.0	360.5	362.8	362.8
Managed data and networks	141.0	132.0	130.7	123.1	116.0
Mobile	732.0	775.0	827.8	849.4	879.1
IT services	355.0	370.0	392.7	413.3	427.8
Other	59.0	66.0	58.2	60.3	62.5
<b>Total gross margin</b>	<b>1,941.0</b>	<b>1,969.0</b>	<b>2,007.2</b>	<b>2,015.1</b>	<b>2,026.1</b>

<b>Balance Sheet (NZ\$m)</b>	2018A	2019A	2020E	2021E	2022E
Working capital	246.0	408.0	455.2	499.0	546.5
Fixed assets	1,039.0	1,012.0	1,005.5	1,102.3	1,117.2
Intangibles	956.0	987.0	969.7	999.6	986.1
Right of use asset	658.0	680.0	677.5	675.4	673.5
Other assets	409.0	507.0	506.0	505.0	504.0
<b>Total funds employed</b>	<b>3,308.0</b>	<b>3,594.0</b>	<b>3,614.0</b>	<b>3,781.1</b>	<b>3,827.3</b>
Net debt/(cash)	1,142.0	1,341.0	1,383.6	1,560.1	1,603.7
Lease liability	474.0	490.0	520.6	549.7	577.4
Other liabilities	209.0	298.0	295.1	292.1	289.3
Shareholder's funds	1,483.0	1,465.0	1,414.8	1,379.2	1,356.9
Minority interests	0	0	0	0	0
<b>Total funding sources</b>	<b>3,308.0</b>	<b>3,594.0</b>	<b>3,614.0</b>	<b>3,781.1</b>	<b>3,827.3</b>

<b>Operating expenses (NZ\$m)</b>	2018A	2019A	2020E	2021E	2022E
Labour	513.0	475.0	502.4	502.2	500.1
Other	398.0	404.0	402.2	396.1	390.1
<b>Total operating expenses</b>	<b>911.0</b>	<b>879.0</b>	<b>904.6</b>	<b>898.3</b>	<b>890.2</b>

<b>Subscribers (000)</b>	2018A	2019A	2020E	2021E	2022E
Postpaid mobile	1,189.0	1,251.0	1,319.5	1,370.3	1,419.2
Prepaid mobile	1,236.0	1,232.0	1,143.7	1,123.0	1,099.8
Broadband	700.0	695.0	687.5	680.7	677.7

<b>ARPU (NZ\$/month)</b>	2018A	2019A	2020E	2021E	2022E
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

## Result analysis

Figure 1. 1H20 result analysis

NZ\$m	1H19	1H20	% chg	Forbar	% diff
<b>Revenue</b>					
<b>Fixed</b>					
Voice	225	199	-11.6%	215	-7.4%
Broadband	344	345	0.3%	344	0.2%
Managed data	121	121	0.0%	93	30.7%
<b>Total fixed</b>	<b>690</b>	<b>665</b>	<b>-3.6%</b>	<b>652</b>	<b>2.0%</b>
Mobile	622	653	5.0%	647	0.9%
Cloud, security and service mgmt	195	219	12.3%	211	4.0%
Procurement and partners	191	208	8.9%	190	9.3%
Other	56	75	33.9%	90	-16.5%
Other gains	0	4	n.m.	0	n.m.
<b>Total revenue</b>	<b>1,754</b>	<b>1,824</b>	<b>4.0%</b>	<b>1,789</b>	<b>1.9%</b>
<b>Gross margin</b>					
<b>Fixed</b>					
Voice	143	124	-13.3%	131	-5.4%
Broadband	168	175	4.2%	172	1.5%
Managed data	66	65	-1.5%	47	37.7%
<b>Total fixed</b>	<b>377</b>	<b>364</b>	<b>-3.4%</b>	<b>351</b>	<b>3.8%</b>
Mobile	376	405	7.7%	387	4.6%
Cloud, security and service mgmt	163	176	8.0%	168	4.8%
Procurement and partners	18	21	16.7%	18	16.9%
Other	25	15	-40.0%	20	-26.1%
Other gains	0	4	n.m.	0	n.m.
<b>Total gross margin</b>	<b>959</b>	<b>985</b>	<b>2.7%</b>	<b>944</b>	<b>4.4%</b>
<b>Operating expenses</b>					
Labour	(250)	(267)	6.8%	(243)	10.0%
Other	(220)	(218)	-0.9%	(194)	12.2%
<b>Total operating expenses</b>	<b>(470)</b>	<b>(485)</b>	<b>3.2%</b>	<b>(437)</b>	<b>11.0%</b>
<b>EBITDA</b>	<b>489</b>	<b>500</b>	<b>2.2%</b>	<b>507</b>	<b>-1.4%</b>
Depreciation & amortisation	(245)	(234)	-4.5%	(243)	-3.7%
<b>EBIT</b>	<b>244</b>	<b>266</b>	<b>9.0%</b>	<b>264</b>	<b>0.8%</b>
Interest	(22)	(28)	27.3%	(22)	27.2%
<b>Net profit before tax</b>	<b>222</b>	<b>238</b>	<b>7.2%</b>	<b>242</b>	<b>-1.6%</b>
Tax	(69)	(70)	1.4%	(70)	0.2%
Equity accounted earnings	0	(1)	n.m.	0	n.m.
<b>Reported NPAT</b>	<b>153</b>	<b>167</b>	<b>9.2%</b>	<b>172</b>	<b>-2.9%</b>
<b>Underlying profit</b>	<b>153</b>	<b>167</b>	<b>9.2%</b>	<b>172</b>	<b>-2.9%</b>
Underlying EPS (cps)	8.3	9.1	9.1%	9.4	-2.9%
Dividend (cps)	12.5	12.5	0.0%	12.5	0.0%

Source: Forsyth Barr analysis

## Earnings revisions

Figure 2. Earnings revisions

NZ\$m	FY20E			FY21E			FY22E		
	Old	New	% chg	Old	New	% chg	Old	New	% chg
Revenue	3,558	3,621	1.8%	3,555	3,640	2.4%	3,585	3,685	2.8%
EBITDA	1,115	1,103	-1.1%	1,112	1,117	0.4%	1,120	1,136	1.4%
EBIT	629	629	0.0%	627	644	2.6%	636	662	4.1%
Underlying profit	414	403	-2.6%	415	417	0.6%	424	431	1.6%
Underlying EPS (cps)	22.5	21.9	-2.6%	22.6	22.7	0.6%	23.1	23.5	1.6%
Dividend (cps)	25.0	25.0	0.0%	25.0	25.0	0.0%	25.0	25.0	0.0%

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 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.58% 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.

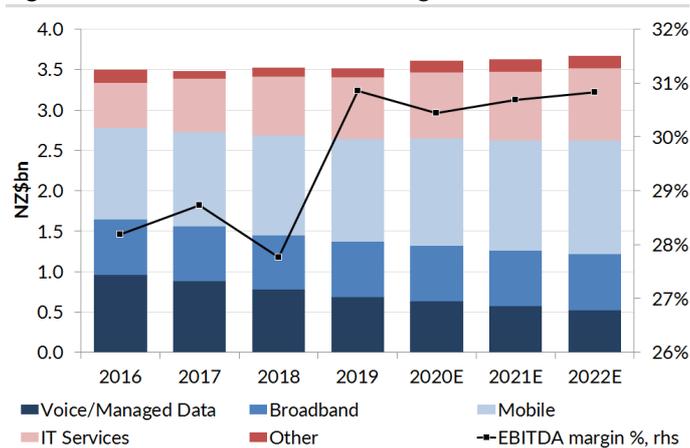
### Financial structure

- **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

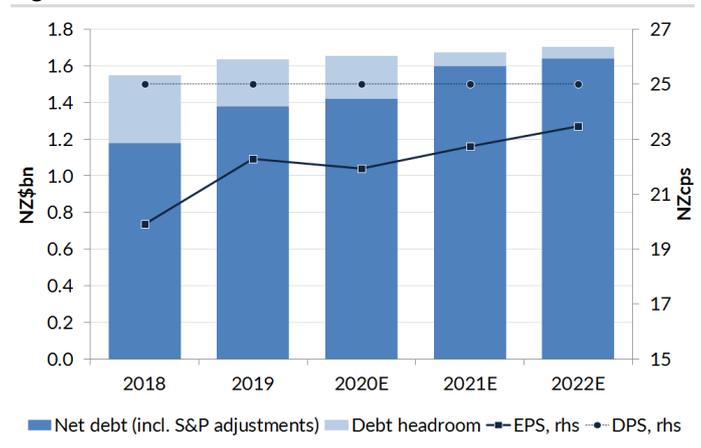
- **Delivery of cost savings:** It is difficult to have insight into deliverability; however, we take comfort from SPK’s investment in simplifying/digitalising systems, processes, and products, and its execution track record.
- **Competitive pressures or slowing growth in mobile and IT services.**
- **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%

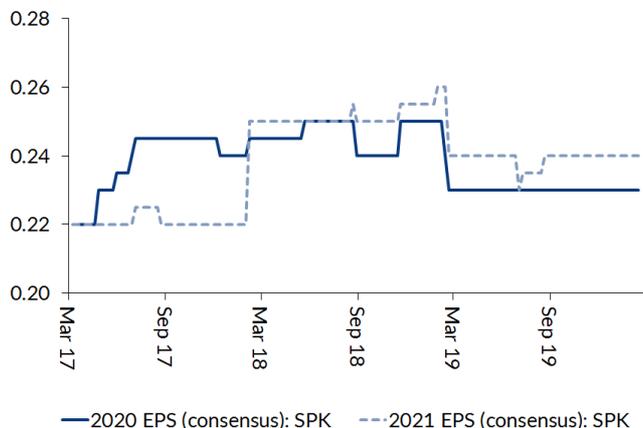
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

**Figure 7. International valuation comparisons**

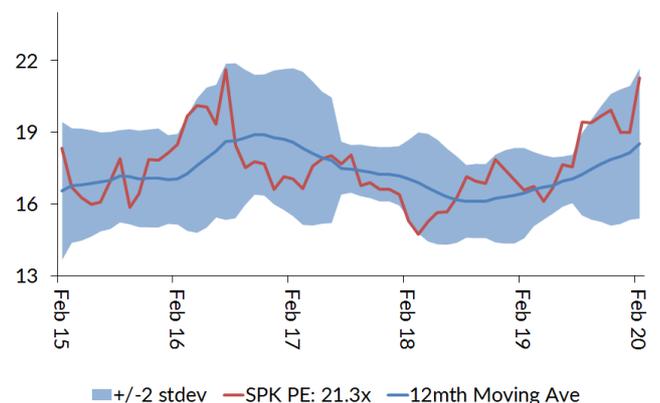
Company	Code	Price	Mkt Cap (m)	PE		EV/EBITDA		EV/EBIT		Cash Yld 2021E
				2020E	2021E	2020E	2021E	2020E	2021E	
Spark NZ	SPK NZ	NZ\$4.78	NZ\$8,777	21.8x	21.0x	9.2x	9.1x	16.1x	15.7x	5.2%
Telstra Corp	TLS AT	A\$3.73	A\$44,362	18.6x	18.8x	7.1x	7.4x	15.5x	15.8x	4.3%
Singapore Telecommunications	ST SP	S\$3.17	S\$51,762	18.6x	16.7x	14.0x	14.0x	29.2x	28.1x	5.4%
BT Group PLC	BT/A LN	£1.56	£15,398	6.7x	6.6x	4.4x	4.4x	9.5x	9.5x	7.3%
Vodafone Group PLC	VOD LN	€1.87	€41,576	21.9x	16.9x	6.7x	6.4x	19.9x	17.6x	5.0%
Orange SA	ORA FP	€13.43	€35,725	12.9x	12.3x	4.8x	4.9x	11.2x	11.3x	5.5%
Deutsche Telekom AG	DTE GR	€15.82	€75,345	15.1x	13.8x	6.1x	5.7x	14.3x	12.7x	4.4%
Swisscom AG	SCMN SW	CHF575.80	CHF29,828	18.9x	20.0x	8.9x	8.9x	19.9x	19.7x	3.8%
Verizon Communications Inc	VZ US	US\$58.16	US\$240,508	12.1x	11.6x	7.8x	7.6x	11.9x	11.5x	4.3%
AT&T Inc	T US	US\$38.20	US\$277,141	15.3x	10.3x	7.8x	7.5x	15.2x	13.7x	5.5%
BCE Inc	BCE CN	C\$65.11	C\$58,853	18.8x	17.8x	8.4x	8.1x	15.1x	14.8x	5.2%
TPG Telecom	TPM AT	A\$8.04	A\$7,460	30.9x	29.9x	12.2x	10.8x	21.4x	18.4x	0.7%
<b>Compc Average:</b>				<b>17.3x</b>	<b>15.9x</b>	<b>8.0x</b>	<b>7.8x</b>	<b>16.7x</b>	<b>15.7x</b>	<b>4.7%</b>
<b>SPK Relative:</b>				<b>26%</b>	<b>32%</b>	<b>15%</b>	<b>16%</b>	<b>-3%</b>	<b>-0%</b>	<b>12%</b>

EV = Current Market Cap + Actual Net Debt

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