

Spark NZ

FY20 – Breaking the Quarter Buck; NEUTRAL

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NEUTRAL

The main news in Spark's (SPK) result was it has eased back on its ambition to sustain its NZ25cps dividend, guiding to NZ23–25cps in FY21. The impact from COVID-19 has further tipped the balance between SPK's commitment to an A- credit rating, and funding medium-term capital requirements (including mobile spectrum, 5G infrastructure, Southern Cross Next cable, Spark Sports). A dividend cut is no fait accompli – SPK has a strong track record on execution, consistently outperforming market expectation, and COVID impacted revenue streams such as mobile roaming will bounce back once lockdowns end. Even with a cut, SPK should still offer an attractive yield in an income scarce world. After a strong share price performance through this volatile year, we downgrade to NEUTRAL principally on valuation grounds.

NZX Code	SPK	Financials: Jun/	20A	21E	22E	23E	Valuation (x)	20A	21E	22E	23E
Share price	NZ\$4.85	NPAT* (NZ\$m)	427.0	394.7	432.3	440.9	EV/EBITDA	9.0	9.1	8.7	8.7
Target price	NZ\$5.20	EPS* (NZc)	23.2	21.4	23.3	23.6	EV/EBIT	15.8	16.3	15.0	15.1
Risk rating	Medium	EPS growth* (%)	4.4	-7.9	8.7	1.2	PE	20.9	22.7	20.8	20.6
Issued shares	1837.0m	DPS (NZc)	25.0	23.0	24.0	24.0	Price / NTA	17.0	16.8	14.5	14.3
Market cap	NZ\$8,910m	Imputation (%)	88	100	100	100	Cash div yld (%)	5.2	4.7	4.9	4.9
Avg daily turnover	2,735k (NZ\$12,276k)	*Based on normalised profits					Gross div yld (%)	6.9	6.6	6.9	6.9

FY20 and FY21 in line with our expectation; guidance a touch below market consensus

SPK's FY20 and FY21 guidance were in line with our expectation, although the latter was a touch below consensus. SPK navigated COVID (with an estimated NZ\$25m EBITDA impact, expanding to NZ\$75m in FY21) hitting its original guidance, albeit with help from various gains on sale. Mobile remains the principal good news story, with gross margin up +7%/NZ\$54m on continued trading up: prepaid to postpaid, higher tier plans, and more data, and despite a c.NZ\$15m revenue impact from lost roaming.

Beyond mobile, growth remains challenging. Cloud, security, and service management delivered +11% headline revenue, but margin pressures and investment in staff means profit growth is minimal. Broadband suffered from the stalling of selling wireless, and an appearance of ARPU pressures. (SPK has ambitions to reignite wireless broadband growth in FY21, supported by 5G's greater capacity and speeds). Legacy voice, GM down -13%/-NZ\$37m, remains the largest headwind. The good news is the base keeps getting smaller, now 12% of SPK's total GM vs. 22% only 3 years ago.

SPK's dividend is a principal focus for investors

SPK is principally owned by income-seeking investors. COVID may have finally brought to an end SPK's ability to manage opex and capex to sustain its dividend. We do not, however, expect cuts to be dramatic. The mobile market is healthy and rational, SPK has a strong track record on execution, COVID impacted revenue streams will bounce back, and it has introduced a dividend reinvestment plan. The next significant test (outside of COVID) will potentially come in FY23 when it may need to pay for spectrum rights for 5G – both the sum and timing of payments (possibly staged) remains uncertain.

Downgrade to NEUTRAL

We downgrade SPK to NEUTRAL. In a world hungry for yield SPK still offers an attractive income, but we view the stock as fairly priced relative to international telco and NZ defensive peers. We view the medium-term risks to earnings and dividends as both balanced and relatively modest.

Spark NZ Ltd (SPK)

 Priced as at 26 Aug 2020 (NZ\$) 4.85

12-month target price (NZ\$)*	5.20	Spot valuations (NZ\$)	
Expected share price return	7.2%	1. DCF	5.64
Net dividend yield	4.8%	2. Sector peer relative	4.77
Estimated 12-month return	12.0%	3. Market relative	5.04

Key WACC assumptions		DCF valuation summary (NZ\$m)	
Risk free rate	1.30%	Total firm value	12,352
Equity beta	0.78	(Net debt)/cash	(1,419)
WACC	5.3%	Less: Capitalised operating leases	(572)
Terminal growth	1.0%	Value of equity	10,361

Profit and Loss Account (NZ\$m)	2019A	2020A	2021E	2022E	2023E	Valuation Ratios	2019A	2020A	2021E	2022E	2023E
Sales revenue	3,533.0	3,623.0	3,533.2	3,625.0	3,659.8	EV/EBITDA (x)	9.2	9.0	9.1	8.7	8.7
Normalised EBITDA	1,090.0	1,113.0	1,094.6	1,147.8	1,148.1	EV/EBIT (x)	16.3	15.8	16.3	15.0	15.1
Depreciation and amortisation	(477.0)	(479.0)	(481.7)	(483.2)	(489.0)	PE (x)	21.8	20.9	22.7	20.8	20.6
Normalised EBIT	613.0	634.0	612.8	664.6	659.1	Price/NTA (x)	18.6	17.0	16.8	14.5	14.3
Net interest	(48.0)	(58.0)	(58.6)	(56.6)	(52.6)	Free cash flow yield (%)	4.0	5.6	5.4	5.7	5.1
Associate income	14.0	1.0	1.0	1.0	11.0	Net dividend yield (%)	5.2	5.2	4.7	4.9	4.9
Tax	(170.0)	(150.0)	(160.6)	(176.7)	(176.6)	Gross dividend yield (%)	6.7	6.9	6.6	6.9	6.9
Minority interests	0	0	0	0	0						
Normalised NPAT	409.0	427.0	394.7	432.3	440.9	Capital Structure	2019A	2020A	2021E	2022E	2023E
Abnormals/other	0	0	0	0	0	Interest cover EBIT (x)	12.8	10.9	10.5	11.7	12.5
Reported NPAT	409.0	427.0	394.7	432.3	440.9	Interest cover EBITDA (x)	22.7	19.2	18.7	20.3	21.8
Normalised EPS (cps)	22.3	23.2	21.4	23.3	23.6	Net debt/ND+E (%)	47.8	48.7	47.6	45.2	44.1
DPS (cps)	25.0	25.0	23.0	24.0	24.0	Net debt/EBITDA (x)	1.2	1.3	1.3	1.1	1.1

Growth Rates	2019A	2020A	2021A	2022A	2023A	Key Ratios	2019A	2020A	2021E	2022E	2023E
Revenue (%)	0.0	2.5	-2.5	2.6	1.0	Return on assets (%)	15.0	14.6	14.0	15.0	14.5
EBITDA (%)	5.8	2.1	-1.7	4.9	0.0	Return on equity (%)	27.9	28.6	26.0	27.3	26.7
EBIT (%)	11.7	3.4	-3.3	8.4	-0.8	Return on funds employed (%)	15.3	15.9	14.4	15.7	15.4
Normalised NPAT (%)	2.3	4.4	-7.6	9.5	2.0	EBITDA margin (%)	30.9	30.7	31.0	31.7	31.4
Normalised EPS (%)	2.2	4.4	-7.9	8.7	1.2	EBIT margin (%)	17.4	17.5	17.3	18.3	18.0
Ordinary DPS (%)	0.0	13.6	-8.0	4.3	0.0	Capex to sales (%)	12.0	11.1	11.4	10.7	12.8

Cash Flow (NZ\$m)	2019A	2020A	2021E	2022E	2023E	Operating Performance	2019A	2020A	2021E	2022E	2023E
EBITDA	1,090.0	1,113.0	1,094.6	1,147.8	1,148.1	Gross margin (NZ\$m)					
Working capital change	(122.0)	3.0	8.5	(15.0)	(2.0)	Voice	282.0	245.0	210.6	182.5	
Interest & tax paid	(179.0)	(194.0)	(219.1)	(233.3)	(229.2)	Broadband	344.0	341.0	341.5	336.8	
Other	(12.0)	(19.0)	0	0	10.0	Managed data and networks	132.0	129.0	126.5	119.0	
Operating cash flow	777.0	903.0	883.9	899.5	926.9	Mobile	775.0	829.0	826.0	897.8	
Capital expenditure	(423.0)	(401.0)	(404.0)	(388.4)	(469.5)	IT services	370.0	399.0	407.8	422.2	
(Acquisitions)/divestments	1.0	25.0	0	0	0	Other	66.0	83.0	74.0	76.7	
Other	(47.0)	(64.0)	(64.2)	(69.7)	(73.0)	Total gross margin	1,969.0	2,026.0	1,986.4	2,035.0	
Funding available/(required)	308.0	463.0	415.7	441.4	384.4						
Dividends paid	(459.0)	(459.0)	(375.4)	(370.4)	(381.1)	Operating expenses (NZ\$m)					
Equity raised/(returned)	0	0	0	0	0	Labour	475.0	511.0	501.0	499.6	
(Increase)/decrease in net debt	(151.0)	4.0	40.3	70.9	3.3	Other	404.0	402.0	390.8	387.7	

Balance Sheet (NZ\$m)	2019A	2020A	2021E	2022E	2023E	Subscribers (000)					
Working capital	408.0	410.0	401.5	416.5	418.6	Postpaid mobile	1,251.0	1,330.0	1,396.7	1,456.6	
Fixed assets	1,012.0	1,015.0	1,019.0	1,046.9	1,078.5	Prepaid mobile	1,232.0	1,161.0	1,105.5	1,055.5	
Intangibles	987.0	968.0	984.4	963.2	1,015.8	Broadband	695.0	709.0	712.4	710.4	707.9
Right of use asset	680.0	784.0	809.1	827.6	846.5						
Other assets	507.0	654.0	655.0	656.0	657.0	ARPU (NZ\$/month)					
Total funds employed	3,594.0	3,831.0	3,869.1	3,910.3	4,016.3	Postpaid mobile	43.8	42.6	42.2	41.8	42.2
Net debt/(cash)	1,341.0	1,419.0	1,378.7	1,307.8	1,304.5	Prepaid mobile	12.2	12.5	12.7	13.0	13.1
Lease liability	490.0	572.0	615.7	658.6	700.9	Broadband	79.9	84.3	87.0	87.3	87.5
Other liabilities	298.0	347.0	356.4	357.7	358.9						
Shareholder's funds	1,465.0	1,493.0	1,518.3	1,586.2	1,652.0						
Minority interests	0	0	0	0	0						
Total funding sources	3,594.0	3,831.0	3,869.1	3,910.3	4,016.3						

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

Figure 1. FY20 result summary

NZ\$m	FY19	FY20	% chg	Forbar	% diff
Revenue					
Fixed					
Voice	441	391	-11.3%	390	0.3%
Broadband	685	680	-0.7%	690	-1.5%
Managed data	242	248	2.5%	242	2.5%
Total fixed	1,368	1,319	-3.6%	1,322	-0.2%
Mobile	1,271	1,288	1.3%	1,318	-2.2%
Cloud, security and service mgmt	400	443	10.8%	432	2.5%
Procurement and partners	365	408	11.8%	383	6.5%
Other	114	130	14.0%	143	-8.8%
Other gains	15	35	133.3%	15	127.3%
Total revenue	3,533	3,623	2.5%	3,613	0.3%
Gross margin					
Fixed					
Voice	282	245	-13.1%	237	3.2%
Broadband	344	341	-0.9%	361	-5.4%
Managed data	132	129	-2.3%	131	-1.3%
Total fixed	758	715	-5.7%	729	-1.9%
Mobile	775	829	7.0%	817	1.5%
Cloud, security and service mgmt	327	353	8.0%	347	1.8%
Procurement and partners	43	46	7.0%	46	0.0%
Other	51	48	-5.9%	43	12.3%
Other gains	15	35	133.3%	15	127.3%
Total gross margin	1,969	2,026	2.9%	1,996	1.5%
Operating expenses					
Labour	(475)	(511)	7.6%	(494)	3.5%
Restructuring costs	0	0	nm	0	nm
Other	(404)	(402)	-0.5%	(402)	0.0%
Total operating expenses	(879)	(913)	3.9%	(896)	1.9%
EBITDA	1,090	1,113	2.1%	1,100	1.1%
Depreciation & amortisation	(477)	(479)	0.4%	(474)	1.1%
EBIT	613	634	3.4%	627	1.2%
Interest	(48)	(58)	20.8%	(57)	1.7%
Net profit before tax	565	576	1.9%	570	1.1%
Tax	(170)	(150)	-11.8%	(167)	-10.3%
Associates/JV losses & other gains	14	1	-92.9%	(1)	-200.0%
Reported NPAT	409	427	4.4%	401	6.4%
Underlying profit	409	427	4.4%	401	6.4%
Underlying EPS (cps)	22.3	23.2	4.4%	21.5	8.2%
Dividend (cps)	25.0	25.0	0.0%	25.0	0.0%

Source: Company reports, Forsyth Barr analysis

Figure 2. Earnings revisions

NZ\$m	FY21E			FY22E			FY23E
	Old	New	% chg	Old	New	% chg	New
Revenue	3,605	3,533	-2.0%	3,690	3,625	-1.8%	3,660
EBITDA	1,092	1,095	0.2%	1,145	1,148	0.2%	1,148
EBIT	619	613	-1.0%	672	665	-1.1%	659
Underlying profit	400	395	-1.3%	438	432	-1.2%	441
Underlying EPS (cps)	21.8	21.4	-1.7%	23.8	23.3	-2.3%	23.6
Dividend (cps)	25.0	23.0	-8.0%	25.0	24.0	-4.0%	24.0

Source: Forsyth Barr analysis

Investment Summary

In a world hungry for yield SPK offers an attractive income, but we view the stock as fairly priced relative to international telco and NZ defensive peers. We view the medium-term risks to earnings and dividends as both balanced and relatively modest.
NEUTRAL

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

- **Dampened by COVID-19:** SPK is principally owned by income-seeking investors. Whilst COVID-19 may have finally brought to an end SPK's ability to sustain its dividend, we do not expect cuts to be dramatic. The mobile market is healthy and rational, SPK has a strong track record on execution, COVID-impacted revenue streams will bounce back, and it has introduced a dividend reinvestment plan. We expect dividends in the range of NZ23–25cps over the medium-term.

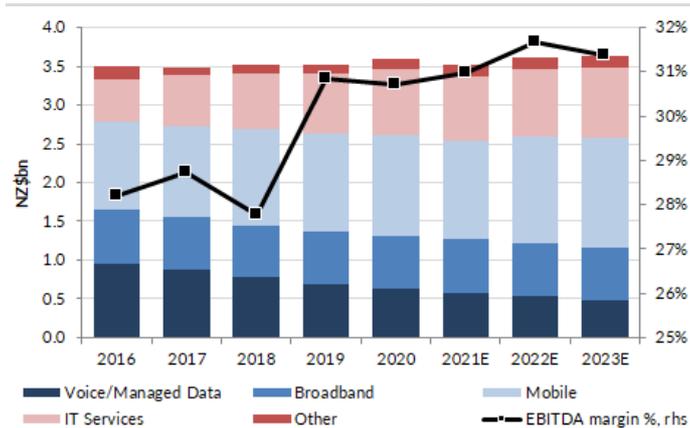
Financial structure

- **Gearing:** SPK has a strong balance sheet with a policy to maintain net debt/EBITDA <1.4x (1.2x at FY20 year-end), and A- S&P credit rating.

Risk factors

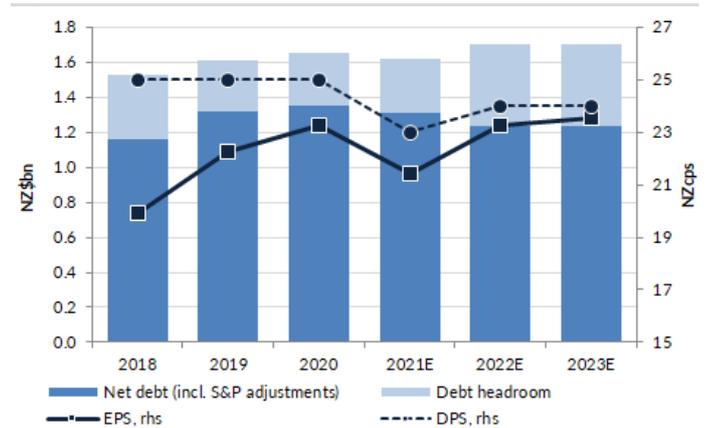
- **Delivery of cost savings:** It is difficult to have insight into deliverability; however, we take comfort from SPK's investment in simplifying/digitalising systems, processes, and products, and its execution track record.
- **Competitive pressures or slowing growth in mobile and IT services.**
-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

Figure 3. SPK revenue and EBITDA margin

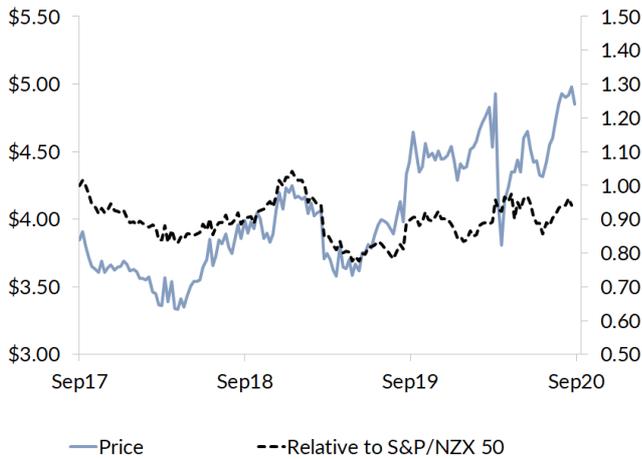


Source: Company reports, Forsyth Barr analysis

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

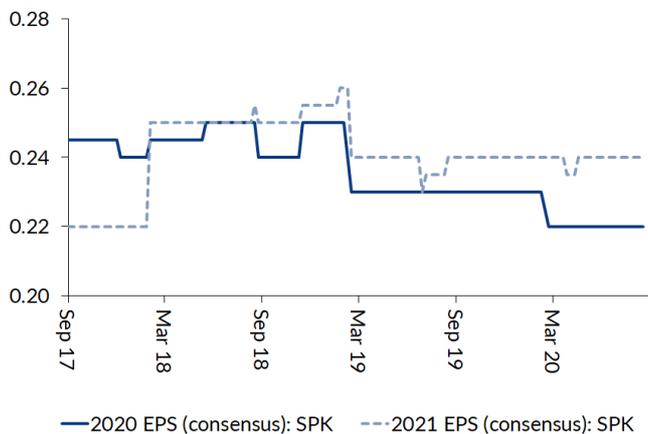
Shareholder	Latest Holding
BlackRock Investment Management	7.5%
The Vanguard Group	5.2%

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

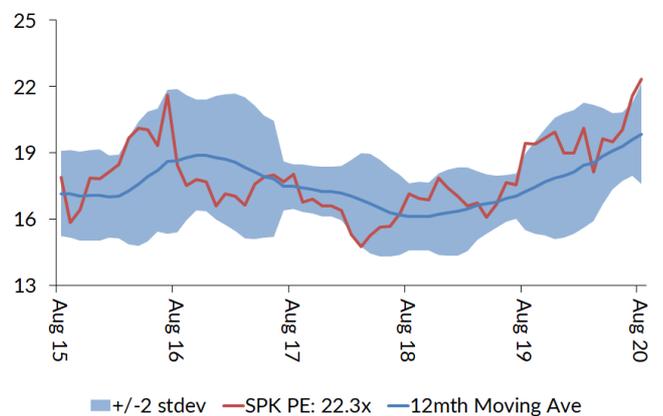
Figure 7. International valuation comparisons

Company	Code	Price	Mkt Cap (m)	PE		EV/EBITDA		EV/EBIT		Cash Yld		
				2021E	2022E	2021E	2022E	2021E	2022E			
Spark NZ	SPK NZ	NZ\$4.85	NZ\$8,910	22.7x	20.8x	9.4x	9.0x	16.9x	15.5x	4.9%		
TELSTRA CORP	TLS AT	A\$2.99	A\$35,501	23.0x	21.5x	7.0x	7.3x	17.7x	18.1x	4.8%		
SINGAPORE TELECOMMUNICATIONS	ST SP	S\$2.30	S\$37,557	15.1x	13.0x	12.3x	12.2x	34.9x	35.1x	5.7%		
BT GROUP PLC	BT/A LN	£1.07	£10,606	5.8x	5.6x	4.0x	4.0x	9.5x	9.4x	7.1%		
VODAFONE GROUP PLC	VOD LN	€1.28	€30,961	20.9x	15.1x	5.9x	5.6x	18.1x	16.2x	7.3%		
ORANGE	ORA FP	€9.97	€26,521	9.4x	8.6x	4.5x	4.4x	10.2x	9.7x	7.0%		
DEUTSCHE TELEKOM AG-REG	DTE GR	€15.22	€72,446	13.2x	11.8x	6.2x	5.9x	16.4x	14.7x	4.3%		
SWISSCOM AG-REG	SCMN SW	CHF510.00	CHF26,419	18.2x	17.8x	8.3x	8.2x	18.1x	17.8x	4.2%		
VERIZON COMMUNICATIONS INC	VZ US	US\$59.42	US\$245,883	12.3x	11.9x	8.0x	7.8x	12.6x	11.9x	4.3%		
AT&T INC	T US	US\$29.90	US\$213,038	9.3x	9.0x	7.0x	6.9x	14.5x	12.8x	7.2%		
BCE INC	BCE CN	C\$57.75	C\$52,225	18.3x	17.0x	8.0x	7.8x	15.5x	15.0x	6.1%		
TPG CORP	TPM AT	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a		
Compcp Average:				14.6x	13.1x	7.1x	7.0x	16.8x	16.1x	5.8%		
EV = Current Market Cap + Actual Net Debt				SPK Relative:		56%	59%	33%	28%	1%	-3%	-15%

Source: *Forsyth Barr analysis, Bloomberg Consensus, Compcp 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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