

Spark NZ

A Beacon of Value; Upgrade to OUTPERFORM

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OUTPERFORM

We upgrade Spark (SPK) to OUTPERFORM. We now expect SPK to navigate the headwinds of COVID-19 without a significant pullback in earnings, and likely maintain its NZ25cps dividend. We believe such an outcome will reinforce SPK's qualities — a solidly positioned business with an impressive execution track record, robust valuation metrics, a strong balance sheet, and an attractive dividend income in a yield hungry world.

NZX Code	SPK	Financials: Jun/	20A	21E	22E	23E	Valuation (x)	20A	21E	22E	23E
Share price	NZ\$4.64	NPAT* (NZ\$m)	427.0	410.8	433.8	461.4	PE	20.0	20.9	20.2	19.3
Target price	NZ\$5.20	EPS* (NZc)	23.2	22.2	23.0	24.1	EV/EBIT	16.1	16.1	15.3	14.9
Risk rating	Medium	EPS growth* (%)	4.4	-4.6	3.9	4.7	EV/EBITDA	9.2	9.2	8.9	8.7
Issued shares	1837.0m	DPS (NZc)	25.0	25.0	25.0	25.0	Price / NTA	16.3	14.7	12.4	11.5
Market cap	NZ\$8,533m	Imputation (%)	88	100	100	100	Cash div yld (%)	5.4	5.4	5.4	5.4
Avg daily turnover	2,887k (NZ\$13,139k)	*Based on normalised profits					Gross div yld (%)	7.2	7.5	7.5	7.5

What's changed?

- **Earnings:** FY21/22/23E EPS +4%/flat/flat; DPS +9%/+4%/flat.

Navigating COVID-19 with earnings and dividend likely intact

Back in August SPK eased on its ambition to sustain its NZ25cps dividend, guiding to NZ23–25cps in FY21, on the back of impacts from COVID-19. We now expect SPK is likely to navigate FY21 with broadly flat yoy operating earnings, cash flow and dividend supported by: (1) a stronger than anticipated economic backdrop benefitting the likes of store and handset sales, bad/doubtful debts, and demand from business customers, (2) mobile and broadband ARPU growth/margin benefit from the sale of and explicit pricing for Lightbox (previously provided free of charge), (3) a NZ\$14m reduction in cash paid for the Telco Development Levy (provisioned for in FY20), (4) margin improvement from additional fixed wireless broadband subscribers, and (5) cost savings where SPK has a strong track record on execution, consistently outperforming market expectation. These benefits should be sustained medium-term, and COVID-19 impacts such as mobile roaming will bounce back once border closures end. Even if we are shown to be too optimistic and SPK's dividend is eased, the stock should still offer an attractive yield in an income scarce world.

A beacon of value in an expensive market

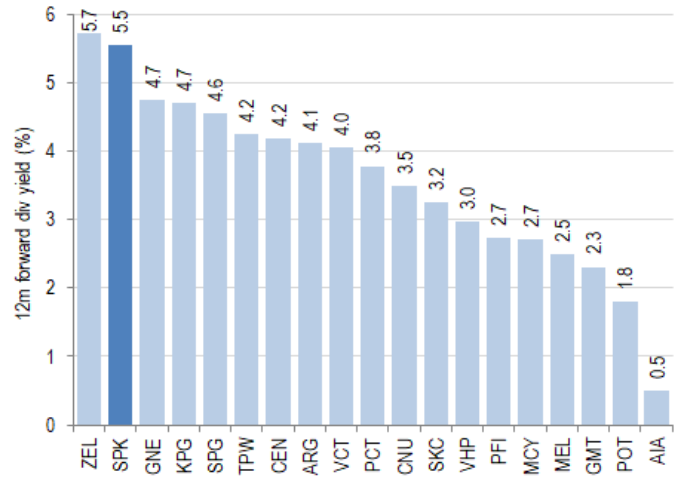
SPK has lagged other defensive exposures in the NZ market in recent months. We believe the stock offers robust valuation metrics and an attractive income relative to other defensive NZ exposures, global telco peers, and fixed income. Key for a solid medium-term earnings outlook, NZ's mobile market (SPK's most important exposure) is healthy and rational. The company has a strong pedigree in reducing costs and navigating market changes. We view the medium-term risks to earnings and dividends as both balanced and relatively modest, and expect better cash flow conversion with working capital growth slowing. SPK's defensive appeal is supported by its strong, A- rated balance sheet which could be further strengthened by possible divestment of property and/or infrastructure assets. We upgrade to OUTPERFORM.

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



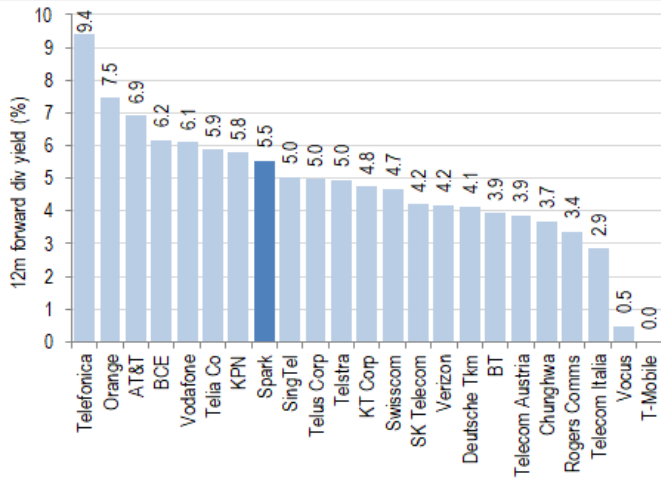
Source: Bloomberg, Forsyth Barr analysis

Figure 2. NZ defensives 12-mth fwd dividend yield (consensus)



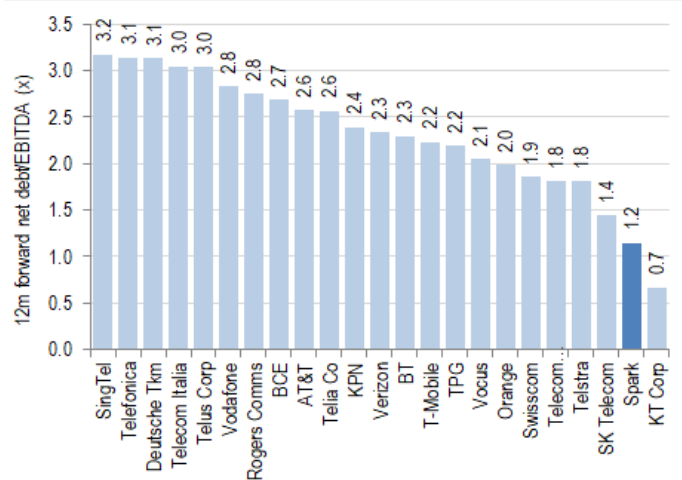
Source: Bloomberg, Forsyth Barr analysis

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



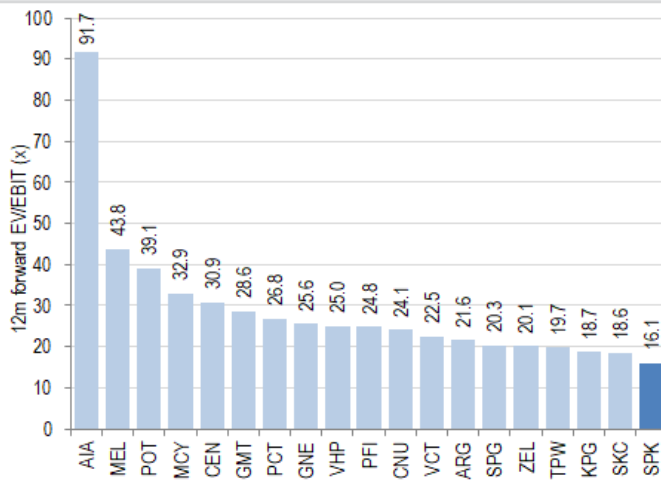
Source: Bloomberg, Forsyth Barr analysis

Figure 4. Telco net debt/EBITDA (consensus)



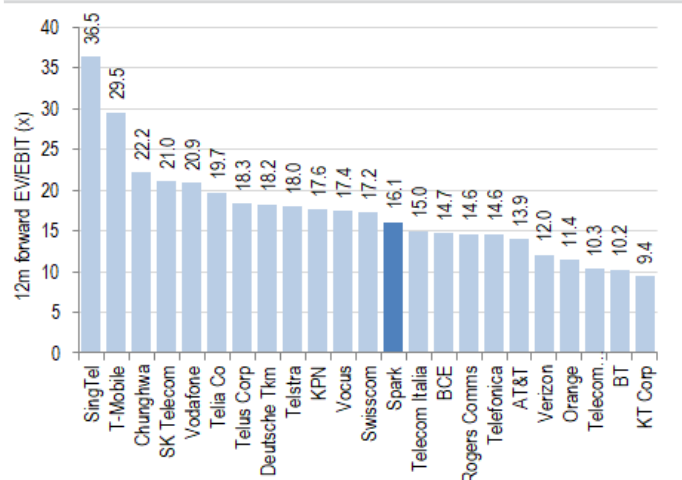
Source: Bloomberg, Forsyth Barr analysis

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

Spark NZ Ltd (SPK)

Priced as at 18 Dec 2020 (NZ\$)

4.65

12-month target price (NZ\$)*

5.20

Expected share price return

11.8%

Net dividend yield

5.4%

Estimated 12-month return

17.2%

Spot valuations (NZ\$)

1. DCF

5.85

2. Sector peer relative

5.09

3. Market relative

5.60

Key WACC assumptions

Risk free rate

1.30%

Equity beta

0.78

WACC

5.3%

Terminal growth

1.0%

DCF valuation summary (NZ\$m)

Total firm value

12,733

(Net debt)/cash

(1,419)

Less: Capitalised operating leases

(572)

Value of equity

10,742

Profit and Loss Account (NZ\$m)	2019A	2020A	2021E	2022E	2023E
Sales revenue	3,533.0	3,623.0	3,560.5	3,631.7	3,688.3
Normalised EBITDA	1,090.0	1,113.0	1,114.5	1,149.9	1,176.0
Depreciation and amortisation	(477.0)	(479.0)	(479.6)	(484.8)	(490.6)
Normalised EBIT	613.0	634.0	634.9	665.1	685.4
Net interest	(48.0)	(58.0)	(57.9)	(55.0)	(49.8)
Associate income	14.0	1.0	1.0	1.0	11.0
Tax	(170.0)	(150.0)	(167.3)	(177.3)	(185.1)
Minority interests	0	0	0	0	0
Normalised NPAT	409.0	427.0	410.8	433.8	461.5
Abnormals/other	0	0	0	0	0
Reported NPAT	409.0	427.0	410.8	433.8	461.5
Normalised EPS (cps)	22.3	23.2	22.2	23.1	24.2
DPS (cps)	25.0	25.0	25.0	25.0	25.0

Growth Rates	2019A	2020A	2021A	2022A	2023A
Revenue (%)	0.0	2.5	-1.7	2.0	1.6
EBITDA (%)	5.8	2.1	0.1	3.2	2.3
EBIT (%)	11.7	3.4	0.1	4.7	3.0
Normalised NPAT (%)	2.3	4.4	-3.8	5.6	6.4
Normalised EPS (%)	2.2	4.4	-4.6	4.0	4.8
Ordinary DPS (%)	0.0	13.6	0.0	0.0	0.0

Cash Flow (NZ\$m)	2019A	2020A	2021E	2022E	2023E
EBITDA	1,090.0	1,113.0	1,114.5	1,149.9	1,176.0
Working capital change	(122.0)	3.0	(9.0)	(10.7)	(7.3)
Interest & tax paid	(179.0)	(194.0)	(225.2)	(232.3)	(234.9)
Other	(12.0)	(19.0)	0	0	10.0
Operating cash flow	777.0	903.0	880.3	906.9	943.7
Capital expenditure	(423.0)	(401.0)	(410.4)	(389.1)	(472.6)
(Acquisitions)/divestments	1.0	25.0	0	0	0
Other	(47.0)	(64.0)	(64.2)	(69.7)	(73.0)
Funding available/(required)	308.0	463.0	405.8	448.0	398.2
Dividends paid	(459.0)	(459.0)	(334.8)	(340.1)	(345.3)
Equity raised/(returned)	0	0	3.1	0	0
(Increase)/decrease in net debt	(151.0)	4.0	74.1	108.0	52.9

Balance Sheet (NZ\$m)	2019A	2020A	2021E	2022E	2023E
Working capital	408.0	410.0	419.0	429.7	437.1
Fixed assets	1,012.0	1,015.0	1,025.5	1,052.6	1,084.8
Intangibles	987.0	968.0	986.4	965.2	1,018.4
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
Total funds employed	3,594.0	3,831.0	3,895.1	3,931.1	4,043.8
Net debt/(cash)	1,341.0	1,419.0	1,344.9	1,236.9	1,184.1
Lease liability	490.0	572.0	615.7	658.6	700.9
Other liabilities	298.0	347.0	356.4	357.7	358.9
Shareholder's funds	1,465.0	1,493.0	1,578.1	1,677.8	1,800.0
Minority interests	0	0	0	0	0
Total funding sources	3,594.0	3,831.0	3,895.1	3,931.1	4,043.8

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

Valuation Ratios	2019A	2020A	2021E	2022E	2023E
EV/EBITDA (x)	9.3	9.2	9.2	8.9	8.7
EV/EBIT (x)	16.5	16.1	16.1	15.3	14.9
PE (x)	20.9	20.0	21.0	20.2	19.2
Price/NTA (x)	17.9	16.3	14.7	12.4	11.4
Free cash flow yield (%)	4.1	5.9	5.5	6.1	5.5
Net dividend yield (%)	5.4	5.4	5.4	5.4	5.4
Gross dividend yield (%)	6.9	7.2	7.5	7.5	7.5

Capital Structure	2019A	2020A	2021E	2022E	2023E
Interest cover EBIT (x)	12.8	10.9	11.0	12.1	13.8
Interest cover EBITDA (x)	22.7	19.2	19.3	20.9	23.6
Net debt/ND+E (%)	47.8	48.7	46.0	42.4	39.7
Net debt/EBITDA (x)	1.2	1.3	1.2	1.1	1.0

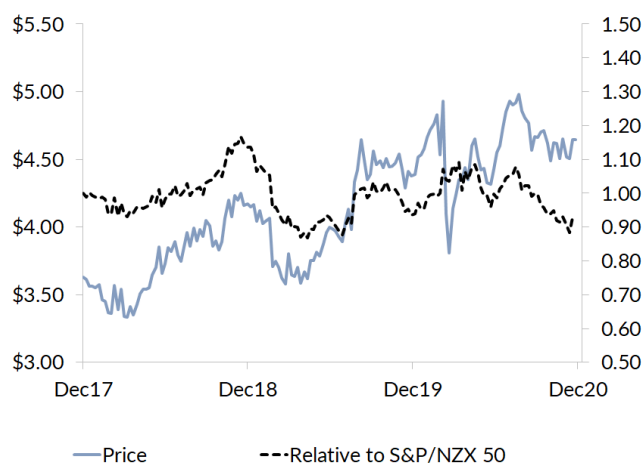
Key Ratios	2019A	2020A	2021E	2022E	2023E
Return on assets (%)	15.0	14.6	14.5	15.0	15.1
Return on equity (%)	27.9	28.6	26.0	25.9	25.6
Return on funds employed (%)	15.3	15.9	14.9	15.6	16.0
EBITDA margin (%)	30.9	30.7	31.3	31.7	31.9
EBIT margin (%)	17.4	17.5	17.8	18.3	18.6
Capex to sales (%)	12.0	11.1	11.5	10.7	12.8
Capex to depreciation (%)	132	124	126	118	142
Imputation (%)	75	88	100	100	100
Pay-out ratio (%)	112	108	113	108	103

Operating Performance	2019A	2020A	2021E	2022E	2023E
Gross margin (NZ\$m)					
Voice	282.0	245.0	209.1	185.1	160.8
Broadband	344.0	341.0	351.3	349.4	346.6
Managed data and networks	132.0	129.0	126.5	119.0	112.0
Mobile	775.0	829.0	833.8	883.8	931.9
IT services	370.0	399.0	408.7	423.1	438.0
Other	66.0	83.0	74.0	76.7	79.5
Total gross margin	1,969.0	2,026.0	2,003.4	2,037.1	2,068.8

Operating expenses (NZ\$m)	2019A	2020A	2021E	2022E	2023E
Labour	475.0	511.0	501.0	499.6	509.9
Other	404.0	402.0	387.9	387.6	387.5
Total operating expenses	879.0	913.0	888.9	887.2	897.4

Subscribers (000)	2019A	2020A	2021E	2022E	2023E
Postpaid mobile	1,251.0	1,330.0	1,396.7	1,456.6	1,520.7
Prepaid mobile	1,232.0	1,161.0	1,105.5	1,055.5	1,008.4
Broadband	695.0	709.0	712.4	710.4	707.9

ARPU (NZ\$/month)	2019A	2020A	2021E	2022E	2023E
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

Figure 7. Price performance


Source: Forsyth Barr analysis

Figure 8. Substantial shareholders

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

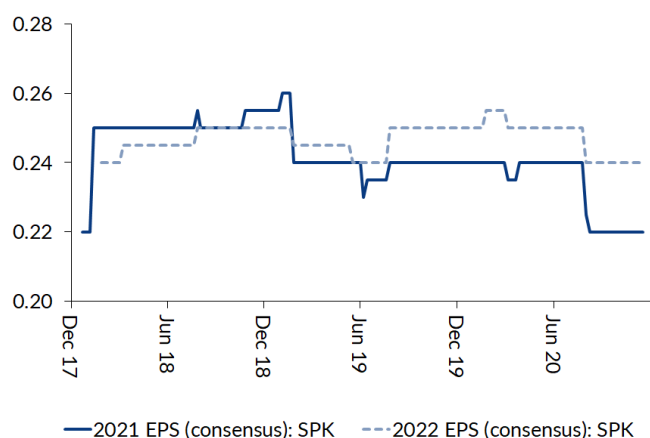
Source: NZX, Forsyth Barr analysis, NOTE: based on SPH notices only

Figure 9. International valuation comparisons

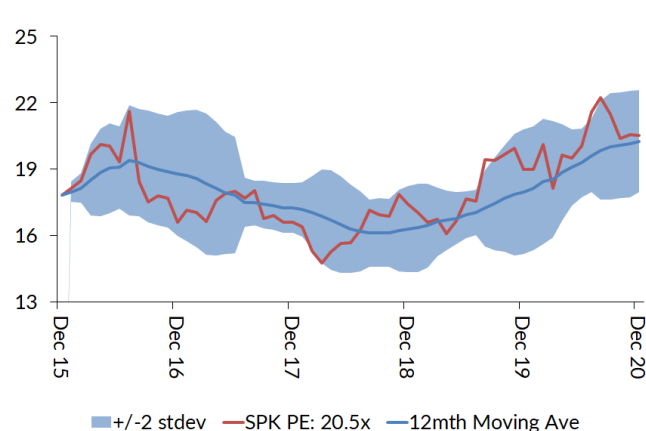
Company	Code	Price	Mkt Cap (m)	PE 2021E	PE 2022E	EV/EBITDA 2021E	EV/EBITDA 2022E	EV/EBIT 2021E	EV/EBIT 2022E	Cash Yld 2022E
(metrics re-weighted to reflect SPK's balance date - June)										
Spark NZ	SPK NZ	NZ\$4.65	NZ\$8,533	20.9x	20.2x	8.9x	8.7x	15.7x	15.0x	5.4%
TELSTRA CORP	TLS AT	A\$3.02	A\$35,918	22.9x	21.7x	7.1x	7.4x	17.6x	17.9x	4.9%
SINGAPORE TELECOMMUNICATIONS	ST SP	S\$2.36	S\$38,537	18.0x	14.5x	13.0x	12.6x	38.5x	35.2x	5.3%
BT GROUP PLC	BT/A LN	£1.37	£13,611	7.1x	6.9x	4.4x	4.3x	10.4x	10.0x	5.5%
VODAFONE GROUP PLC	VOD LN	€1.44	€34,884	19.9x	16.0x	7.0x	6.8x	21.1x	18.8x	6.1%
ORANGE	ORA FP	€9.78	€26,026	9.6x	8.7x	4.4x	4.3x	10.2x	9.7x	7.4%
DEUTSCHE TELEKOM AG-REG	DTE GR	€14.88	€70,851	13.8x	12.4x	6.1x	5.6x	15.4x	14.0x	4.2%
SWISSCOM AG-REG	SCMN SW	CHF470.50	CHF24,373	16.9x	16.8x	7.7x	7.7x	17.4x	17.4x	4.6%
VERIZON COMMUNICATIONS INC	VZ US	US\$60.56	US\$250,582	12.3x	11.9x	7.9x	7.7x	12.5x	11.8x	4.2%
AT&T INC	T US	US\$30.60	US\$218,020	9.8x	9.4x	7.1x	7.0x	14.7x	12.8x	7.0%
BCE INC	BCE CN	C\$55.96	C\$50,606	17.7x	16.2x	7.8x	7.6x	14.8x	14.3x	6.3%
TPG CORP	TPM AT	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Compco Average:				14.8x	13.5x	7.3x	7.1x	17.2x	16.2x	5.6%
SPK Relative:				42%	50%	23%	22%	-9%	-8%	-3%

EV = Current Market Cap + Actual Net Debt

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

Figure 10. Consensus EPS momentum (NZ\$)


Source: Forsyth Barr analysis

Figure 11. One year forward PE (x)


Source: Forsyth Barr analysis

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