FORSYTH BARR

NEW ZEALAND EQUITY RESEARCH | TELECOMMUNICATIONS | FIXED, MOBILE, IT
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Spark NZ
1H21 — Paddling Hard Below the Surface

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OUTPERFORM

Spark (SPK) delivered another very sound performance, navigating COVID border closures and intensifying competition in broadband to deliver stable operating earnings. Key positives remain (1) a resilient contribution from mobile, with underlying growth offsetting the loss of international roaming, and (2) SPK's ability to find cost efficiencies. We continue to see appeal in SPK's consistent delivery, solid market position (particularly mobile), A- rated balance sheet, and attractive dividend yield. Maintain OUTPERFORM.

NZX Code	SPK
Share price	NZ$4.66
Target price	NZ$5.00
Risk rating	Medium
Issued shares	1837.0m
Market cap	NZ$8,561m
Avg daily turnover	2,934k (NZ$13,410k)

Financials: Jun/	20A	21E	22E	23E
NPAT* (NZ$m)	427.0	356.7	380.4	424.8
EPS* (NZc)	23.2	19.3	20.2	22.2
EPS growth* (%)	4.4	-17.1	5.0	10.0
DPS (NZc)	25.0	25.0	25.0	25.0
Imputation (%)	88	100	99	89
*Based on normalised profits				

Valuation (x)	20A	21E	22E	23E
PE	20.0	24.2	23.0	20.9
EV/EBIT	16.1	18.3	17.3	16.1
EV/EBITDA	9.2	9.3	9.3	8.9
Price / NTA	16.3	15.2	13.3	12.5
Cash div yld (%)	5.4	5.4	5.4	5.4
Gross div yld (%)	7.2	7.5	7.4	7.2

Resilient result a creditable outcome

SPK delivered stable EBITDA with mobile growth and cost savings offsetting impacts from COVID border closures and competitive pressures on broadband margins. The result includes a one-off NZ$17m provision (within Voice) to "refund historical wire maintenance charges" (copper charges that continued when customers transitioned to fibre). Excluding this impact, SPK's underlying EBITDA was ahead of our expectation.

Mobile remains the principal good news story, with a gross margin flat despite a NZ$26m revenue impact from lost high-margin roaming. Mobile services revenue, up +4% excl. roaming, continues to benefit from customers trading up: prepaid to postpaid, higher tier plans, and more data. Conversely, the most notable operating trend change was the intensification of broadband competition (gross margin down -5%/-NZ$9m), which SPK attributed, in part, to slower market growth with borders closed to migrants. SPK expects continued pressure as it protects market share. Greater success in adding fixed wireless customers (9k added in 1H lagged its FY21 40k target) would provide some offset. Outside mobile and broadband operating trends remain largely unchanged.

Dividend maintained

SPK has tweaked FY21 guidance, narrowing EBITDA to NZ$1,100–1,130m (from NZ$1,090–1,130m). This includes a c.NZ$50m impact from COVID, mostly roaming. The eventual opening of borders, plus the non-recurring provision, represents c.NZ$70m that should return to SPK's EBITDA in years ahead. Importantly (given the yield focus of SPK's shareholder base), SPK affirmed the dividend will be retained at NZ25cps (vs. prior NZ23–25cps guidance). Changes to our operating earnings have been minor, with a delay in a return in roaming from 2Q CY22, and broadband margin pressures offset by cost out: EBITDA FY21/22/23E -1%/-2%/flat.

Review of infrastructure assets

SPK is undertaking a review of its infrastructure asset portfolio, with divestments possible. We view this as sensible given (1) the high valuation being placed on these types of assets globally, and (2) the entry of new players into the NZ market, reducing SPK's strategic rationale for owning. Datacentres, exchanges, and sub-sea cables are assets where there may be a higher value owner. We suspect a sale of mobile assets is unlikely given SPK (and Vodafone's) network advantage, and the barrier to entry they provide.

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Spark NZ Ltd (SPK)

Priced as at 24 Feb 2021 (NZ$)	**4.66**

12-month target price (NZ$)*	**5.00**
Expected share price return	7.3%
Net dividend yield	5.4%
Estimated 12-month return	12.7%

Key WACC assumptions	
Risk free rate	2.30%
Equity beta	0.78
WACC	5.7%
Terminal growth	1.0%

Profit and Loss Account (NZ$m)	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
Sales revenue	3,533	3,623	3,595	3,634	3,705
Normalised EBITDA	**1,090**	**1,113**	**1,104**	**1,116**	**1,161**
Depreciation and amortisation	(477)	(479)	(541)	(518)	(519)
Normalised EBIT	**613**	**634**	**563**	**598**	**642**
Net interest	(48)	(58)	(62)	(64)	(58)
Associate income	14	1	1	1	11
Tax	(170)	(150)	(145)	(155)	(170)
Minority interests	0	0	0	0	0
Normalised NPAT	**409**	**427**	**357**	**380**	**425**
Abnormals/other	0	0	0	0	0
Reported NPAT	**409.0**	**427.0**	**356.7**	**380.4**	**424.8**
Normalised EPS (cps)	22.3	23.2	19.3	20.2	22.2
DPS (cps)	25.0	25.0	25.0	25.0	25.0

Growth Rates	**2019A**	**2020A**	**2021A**	**2022A**	**2023A**
Revenue (%)	0.0	2.5	-0.8	1.1	1.9
EBITDA (%)	5.8	2.1	-0.8	1.1	4.1
EBIT (%)	11.7	3.4	-11.3	6.3	7.4
Normalised NPAT (%)	2.3	4.4	-16.5	6.7	11.7
Normalised EPS (%)	2.2	4.4	-17.1	5.0	10.0
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**	**1,103.9**	**1,115.8**	**1,161.2**
Working capital change	(122.0)	3.0	(9.2)	(4.6)	(12.5)
Interest & tax paid	(179.0)	(194.0)	(206.9)	(218.6)	(228.2)
Other	(12.0)	(19.0)	0	0	10.0
Operating cash flow	**777.0**	**903.0**	**887.8**	**892.6**	**930.5**
Capital expenditure	(423.0)	(401.0)	(406.5)	(389.4)	(474.4)
(Acquisitions)/divestments	1.0	25.0	0	0	0
Other	(47.0)	(64.0)	(70.2)	(81.1)	(83.3)
Funding available/(required)	**308.0**	**463.0**	**411.1**	**422.1**	**372.8**
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**	**79.4**	**82.0**	**27.5**

Balance Sheet (NZ$m)	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
Working capital	408.0	410.0	419.2	423.8	436.3
Fixed assets	1,012.0	1,015.0	1,002.3	1,034.2	1,071.0
Intangibles	987.0	968.0	952.8	905.2	936.8
Right of use asset	680.0	784.0	948.6	956.8	965.0
Other assets	507.0	654.0	655.0	656.0	657.0
Total funds employed	**3,594.0**	**3,831.0**	**3,977.9**	**3,975.9**	**4,066.1**
Net debt/(cash)	1,341.0	1,419.0	1,339.6	1,257.6	1,230.1
Lease liability	490.0	572.0	751.1	784.4	816.4
Other liabilities	298.0	347.0	363.2	363.5	363.6
Shareholder's funds	1,465.0	1,493.0	1,524.1	1,570.4	1,655.9
Minority interests	0	0	0	0	0
Total funding sources	**3,594.0**	**3,831.0**	**3,977.9**	**3,975.9**	**4,066.1**

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

Spot valuations (NZ$)	
1. DCF	5.42
2. Sector peer relative	4.12
3. Market relative	4.60

DCF valuation summary (NZ$m)	
Total firm value	11,952
(Net debt)/cash	(1,419)
Less: Capitalised operating leases	(572)
Value of equity	9,961

Valuation Ratios	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
EV/EBITDA (x)	9.3	9.2	9.3	9.3	8.9
EV/EBIT (x)	16.5	16.1	18.3	17.3	16.1
PE (x)	20.9	20.0	24.2	23.0	20.9
Price/NTA (x)	17.9	16.3	15.2	13.3	12.5
Free cash flow yield (%)	4.1	5.9	5.6	5.9	5.3
Net dividend yield (%)	5.4	5.4	5.4	5.4	5.4
Gross dividend yield (%)	6.9	7.2	7.5	7.4	7.2

Capital Structure	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
Interest cover EBIT (x)	12.8	10.9	9.0	9.4	11.0
Interest cover EBITDA (x)	22.7	19.2	17.7	17.5	19.9
Net debt/ND+E (%)	47.8	48.7	46.8	44.5	42.6
Net debt/EBITDA (x)	1.2	1.3	1.2	1.1	1.1

Key Ratios	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
Return on assets (%)	15.0	14.6	12.6	13.3	14.0
Return on equity (%)	27.9	28.6	23.4	24.2	25.7
Return on funds employed (%)	15.3	15.9	13.2	14.3	15.3
EBITDA margin (%)	30.9	30.7	30.7	30.7	31.3
EBIT margin (%)	17.4	17.5	15.7	16.5	17.3
Capex to sales (%)	12.0	11.1	11.3	10.7	12.8
Capex to depreciation (%)	132	124	115	116	140
Imputation (%)	75	88	100	99	89
Pay-out ratio (%)	112	108	130	124	112

Operating Performance	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
Gross margin (NZ$m)					
Voice	282.0	245.0	193.6	184.1	157.5
Broadband	344.0	341.0	324.9	310.9	304.8
Managed data and networks	132.0	129.0	133.4	128.3	123.3
Mobile	775.0	829.0	830.3	863.8	940.7
IT services	370.0	399.0	411.3	421.9	432.6
Other	66.0	83.0	80.2	83.3	86.4
Total gross margin	**1,969.0**	**2,026.0**	**1,973.8**	**1,992.2**	**2,045.4**
Operating expenses (NZ$m)					
Labour	475.0	511.0	493.0	490.5	499.1
Other	404.0	402.0	376.9	385.9	385.1
Total operating expenses	**879.0**	**913.0**	**869.9**	**876.4**	**884.2**
Subscribers (000)					
Postpaid mobile	1,251.0	1,330.0	1,386.1	1,454.3	1,547.7
Prepaid mobile	1,232.0	1,161.0	949.0	892.2	850.1
Broadband	695.0	709.0	700.0	694.5	688.5
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

Result analysis

Figure 1. 1H21 result summary

NZ$m	1H20	1H21	% chg	Forbar	% diff
Revenue					
Fixed					
Voice	199	158	-20.6%	170	-7.0%
Broadband	345	337	-2.3%	346	-2.7%
Managed data	121	123	1.7%	124	-0.8%
Total fixed	**665**	**618**	**-7.1%**	**640**	**-3.5%**
Mobile	653	651	-0.3%	636	2.4%
Cloud, security and service mgmt	219	229	4.6%	225	1.8%
Procurement and partners	208	237	13.9%	192	23.1%
Other	75	57	-24.0%	70	-18.8%
Other gains	4	4	n.m.	6	n.m.
Total revenue	**1,824**	**1,796**	**-1.5%**	**1,770**	**1.5%**
Gross margin					
Fixed					
Voice	124	90	-27.4%	106	-15.5%
Broadband	175	166	-5.1%	175	-4.9%
Managed data	65	68	4.6%	64	7.1%
Total fixed	**364**	**324**	**-11.0%**	**344**	**-5.9%**
Mobile	405	407	0.5%	404	0.7%
Cloud, security and service mgmt	176	179	1.7%	176	1.5%
Procurement and partners	21	21	0.0%	18	16.4%
Other	15	28	86.7%	24	18.9%
Other gains	4	4	n.m.	6	n.m.
Total gross margin	**985**	**963**	**-2.2%**	**973**	**-1.0%**
Operating expenses					
Labour	(267)	(255)	-4.5%	(262)	-2.7%
Other	(218)	(206)	-5.5%	(207)	-0.4%
Total operating expenses	**(485)**	**(461)**	**-4.9%**	**(469)**	**-1.7%**
EBITDA	**500**	**502**	**0.4%**	**504**	**-0.3%**
Depreciation & amortisation	(234)	(263)	12.4%	(237)	11.1%
EBIT	**266**	**239**	**-10.2%**	**267**	**-10.5%**
Interest	(28)	(26)	-7.1%	(29)	-10.2%
Net profit before tax	**238**	**213**	**-10.5%**	**238**	**-10.5%**
Tax	(70)	(65)	-7.1%	(69)	-5.8%
Equity accounted earnings	(1)	0	n/a	0	n/a
Reported NPAT	**167**	**148**	**-11.4%**	**169**	**-12.5%**
Underlying profit	**167**	**148**	**-11.4%**	**169**	**-12.5%**
Underlying EPS (cps)	9.1	8.0	-11.8%	9.2	-12.5%
Dividend (cps)	12.5	12.5	0.0%	12.5	0.0%

Source: Forsyth Barr analysis

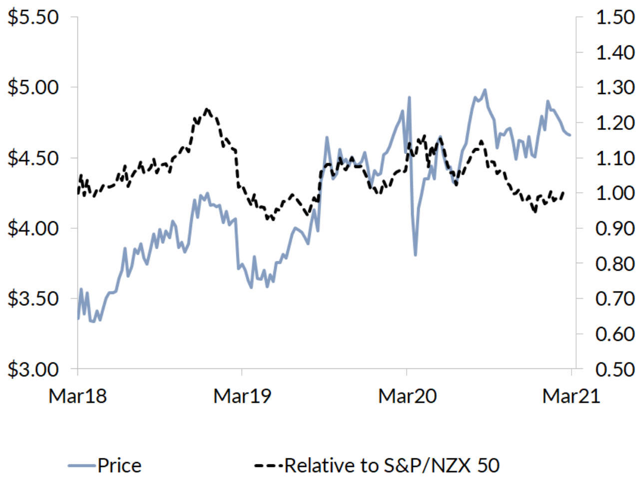
Earnings revisions

Figure 2. Forecast earnings changes

	FY21E			FY22E			FY23E		
NZ$m	**Old**	**New**	**% chg**	**Old**	**New**	**% chg**	**Old**	**New**	**% chg**
Revenue	3,556	3,595	1.1%	3,619	3,634	0.4%	3,681	3,705	0.7%
EBITDA	1,111	1,104	-0.7%	1,142	1,116	-2.3%	1,167	1,161	-0.5%
EBIT	632	563	-10.9%	657	598	-9.0%	677	642	-5.1%
Underlying profit	409	357	-12.7%	428	380	-11.2%	455	425	-6.7%
Underlying EPS (cps)	22.1	19.3	-12.7%	22.8	20.2	-11.1%	23.8	22.2	-6.5%
Dividend (cps)	25.0	25.0	0.0%	25.0	25.0	0.0%	25.0	25.0	0.0%

Source: Forsyth Barr analysis

Figure 3. Price performance



Source: Forsyth Barr analysis

Figure 4. Substantial shareholders

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

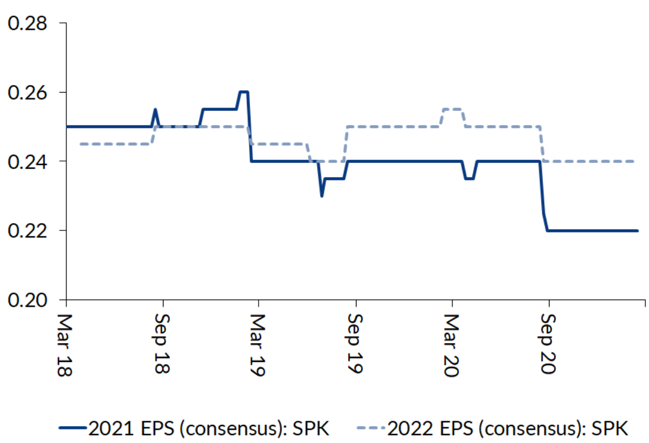
Source: NZX, Forsyth Barr analysis, NOTE: based on SPH notices only

Figure 5. 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)	2021E	2022E	2021E	2022E	2021E	2022E	2022E
Spark NZ	**SPK NZ**	**NZ$4.66**	**NZ$8,561**	**24.2x**	**23.0x**	**9.0x**	**8.9x**	**17.7x**	**16.7x**	**5.4%**
TELSTRA CORP	TLS AT	A$3.23	A$38,415	22.6x	22.6x	7.3x	7.5x	18.5x	18.2x	5.2%
SINGAPORE TELECOMMUNICATIONS	ST SP	S$2.36	S$38,973	18.5x	15.3x	13.2x	12.7x	40.0x	36.6x	5.2%
BT GROUP PLC	BT/A LN	£1.32	£13,120	6.9x	6.6x	4.3x	4.2x	10.2x	9.8x	5.6%
VODAFONE GROUP PLC	VOD LN	€1.51	€34,869	19.1x	15.2x	6.9x	6.9x	21.1x	18.5x	6.1%
ORANGE	ORA FP	€9.79	€26,042	7.6x	9.1x	4.1x	4.3x	9.9x	9.7x	7.4%
DEUTSCHE TELEKOM AG-REG	DTE GR	€14.72	€70,089	13.5x	12.2x	5.6x	5.3x	15.3x	13.8x	4.2%
SWISSCOM AG-REG	SCMN SW	CHF467.50	CHF24,217	16.4x	17.0x	7.5x	7.6x	17.0x	17.3x	4.7%
VERIZON COMMUNICATIONS INC	VZ US	US$56.95	US$235,651	12.2x	11.1x	7.7x	7.4x	12.1x	11.3x	4.5%
AT&T INC	T US	US$29.30	US$208,792	<0x	9.3x	8.9x	6.9x	36.4x	13.3x	7.2%
BCE INC	BCE CN	C$55.08	C$49,815	18.7x	16.9x	7.8x	7.5x	14.9x	14.6x	6.5%
TPG CORP	TPM AT	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
			Compco Average:	**15.0x**	**13.5x**	**7.4x**	**7.0x**	**19.5x**	**16.3x**	**5.7%**
EV = Current Market Cap + Actual Net Debt			**SPK Relative:**	**61%**	**70%**	**23%**	**27%**	**-9%**	**2%**	**-5%**

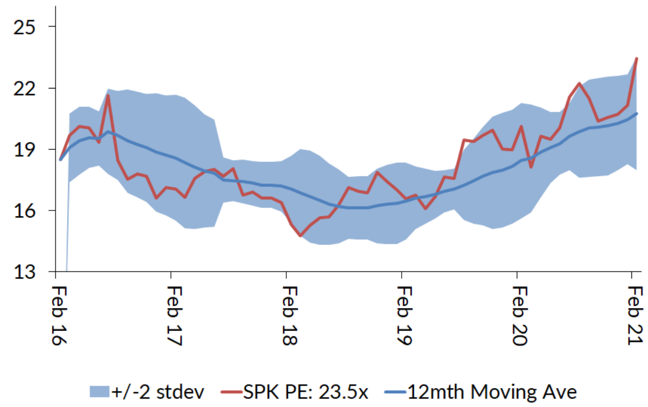
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (SPK) companies fiscal year end

Figure 6. Consensus EPS momentum (NZ$)



Source: Forsyth Barr analysis

Figure 7. One year forward PE (x)



Source: Forsyth Barr analysis

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