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NEW ZEALAND EQUITY RESEARCH | UTILITIES | ELECTRICITY GENERATOR/RETAILER
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Trustpower
Cautious on COVID — FY20 Result Review

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OUTPERFORM

FY20 wasn't a great year for Trustpower (TPW) and the result confirmed that. FY20 EBITDAF was -16% lower than FY19 at NZ $186m with several factors including weaker generation volumes at lower prices, increased operating costs, metering sales and lower avoided cost of transmission revenue (ACOT) all combining to lower earnings. With the outlook uncertain, TPW also decided to trim its final dividend -1.5cps to 15.5cps. Relative to expectations, the result was broadly in line, however, we have lowered our FY21 EBITDAF forecast -1.7% to NZ$199m, FY21 dividend forecast -1.5cps to 32.5cps and lowered our target price -25cps to $7.50. Nevertheless, TPW is operating in a sector we like that faces relatively low COVID-19 downside risk and we expect dividends to rebound quickly. We retain our OUTPERFORM rating.

NZX Code	TPW	Financials: Mar/	20A	21E	22E	23E	Valuation (x)	20A	21E	22E	23E
Share price	NZ$7.14	NPAT* (NZ$m)	74.2	94.2	101.8	111.7	EV/EBITDA	15.2	14.4	13.8	12.9
Target price	NZ$7.50	EPS* (NZc)	23.6	30.0	32.4	35.6	EV/EBIT	19.7	18.9	17.8	16.4
Risk rating	Low	EPS growth* (%)	-36.4	27.1	8.0	9.7	PE	30.2	23.8	22.0	20.1
Issued shares	313.0m	DPS (NZc)	32.5	32.5	34.0	35.0	Price / NTA	2.1	2.1	2.1	2.1
Market cap	NZ$2,235m	Imputation (%)	100	100	100	100	Cash div yld (%)	4.6	4.6	4.8	4.9
Avg daily turnover	53.7k (NZ$389k)	*Based on normalised profits					Gross div yld (%)	6.3	6.3	6.6	6.8

FY20 result broadly in line with expectations

The FY20 result was broadly in line with expectations, but after factoring in IFRS movements was a slight miss. FY20 was a difficult year for TPW. Wholesale electricity market conditions were not favourable and an unplanned outage at one of its generation stations did not help either. Of the ~-NZ$44m fall in underlying EBITDAF (EBITDAF pre-IFRS movements), we estimate ~60% will impact future year earnings, and ~40% should not recur.

Impacting reported profit was a +$16.4m gain on the sale of TPW's legacy metering business and a -$7.5m asset impairment, which has raised the spectre of further ACOT revenue reduction post-FY25. Underlying NPAT was down -26% to $75m.

COVID-19 concerns centre on accounts receivable recovery, impacting on TPW's final dividend

TPW's decision to trim its final (fully imputed) dividend -1.5cps to 15.5cps centres on the uncertainty around the ability of customers to pay their electricity bills going forward. Whilst there have been no material issues as yet, small businesses and consumers are still receiving direct government support, which will not continue forever and TPW is uncertain how much bad debts will increase when the government support ends. We believe that TPW's relatively high gearing will have also been a factor in the decision to trim the dividend. That said, the electricity sector should be one of the least affected sectors and we currently anticipate a relatively quick return to dividend growth.

Modest downgrades to earnings and dividend

We have only made modest changes to our forecasts. We have trimmed our FY21 EBITDAF forecast -NZ$4m to NZ$199m, which is slightly below the middle of TPW's wide FY21 EBITDAF guidance range of NZ$190m to NZ$215m. We assume that the 1H21 dividend will be 15.5cps (the same as 2H20), lowering our FY21 dividend forecast -1.5cps to 32.5cps. Whilst we have lowered our target price -25cps to $7.50 we have retained our OUTPERFORM rating. TPW operates in a sector we like and notwithstanding the modest dividend cut, has limited downside risk relative to most companies.

Trustpower Ltd (TPW)

Priced as at 27 May 2020 (NZ$)	**7.14**

12-month target price (NZ$)*	**7.50**
Expected share price return	5.0%
Net dividend yield	4.6%
Estimated 12-month return	9.6%

Spot valuations (NZ$)	
1. DCF	6.94
2. Market multiples	7.22
3. Dividend Yield	7.77

Key WACC assumptions	
Risk free rate	2.00%
Equity beta	0.88
WACC	6.7%
Terminal growth	1.5%

DCF valuation summary (NZ$m)	
Total firm value	2,827
(Net debt)/cash	(617)
Less: Capitalised operating leases	
Value of equity	2,195

Profit and Loss Account (NZ$m)	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
Sales revenue	1,030.1	989.9	937.0	971.8	991.8
Normalised EBITDA	**222.2**	**186.5**	**199.4**	**209.2**	**222.6**
Depreciation and amortisation	(47.2)	(42.6)	(47.2)	(47.1)	(47.1)
Normalised EBIT	**175**	**144**	**152**	**162**	**175**
Net interest	(28)	(32)	(26)	(25)	(24)
Depreciation capex adjustment	19	(2)	9	8	7
Tax	(45)	(32)	(38)	(41)	(45)
Minority interests	(2)	(3)	(3)	(3)	(3)
Normalised NPAT	**117**	**74**	**94**	**102**	**112**
Abnormals/other/depn adj	(26)	21	(6)	(6)	(5)
Reported NPAT	**91**	**95**	**88**	**96**	**106**
Normalised EPS (cps)	37.1	23.6	30.0	32.4	35.6
DPS (cps)	74.0	32.5	32.5	34.0	35.0

Valuation Ratios	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
EV/EBITDA (x)	12.4	15.2	14.4	13.8	12.9
EV/EBIT (x)	15.8	19.7	18.9	17.8	16.4
PE (x)	19.2	30.2	23.8	22.0	20.1
Price/NTA (x)	1.9	2.1	2.1	2.1	2.1
Free cash flow yield (%)	4.0	3.5	4.2	5.5	5.9
Net dividend yield (%)	10.4	4.6	4.6	4.8	4.9
Gross dividend yield (%)	12.6	6.3	6.3	6.6	6.8

Capital Structure	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
Interest cover EBIT (x)	6.8	4.9	6.3	7.1	7.9
Interest cover EBITDA (x)	7.9	5.9	7.5	8.4	9.3
Net debt/ND+E (%)	58.6	64.8	65.7	66.1	65.6
Net debt/EBITDA (x)	2.5	3.3	3.1	2.9	2.7

Growth Rates	**2019A**	**2020A**	**2021A**	**2022A**	**2023A**
Revenue (%)	5.2	-3.9	-5.3	3.7	2.1
EBITDA (%)	-17.6	-16.1	7.0	4.9	6.4
EBIT (%)	-21.6	-17.8	5.8	6.5	8.2
Normalised NPAT (%)	-17.3	-36.4	27.1	8.0	9.7
Normalised EPS (%)	-17.3	-36.4	27.1	8.0	9.7
Ordinary DPS (%)	0.0	-4.4	0.0	4.6	2.9

Key Ratios	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
Return on assets (%)	7.2	8.0	7.2	7.7	8.4
Return on equity (%)	9.7	6.9	8.9	9.7	10.7
Return on funds employed (%)	7.2	5.6	6.4	6.9	7.5
EBITDA margin (%)	21.6	18.8	21.3	21.5	22.4
EBIT margin (%)	17.0	14.5	16.2	16.7	17.7
Capex to sales (%)	3.0	4.5	3.3	3.3	3.3
Capex to depreciation (%)	98	142	92	95	96
Imputation (%)	55	100	100	100	100
Pay-out ratio (%)	199	138	108	105	98

Cash Flow (NZ$m)	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
EBITDA	**222.2**	**186.5**	**199.4**	**209.2**	**222.6**
Working capital change	(47.1)	1.7	(13.4)	8.0	8.9
Interest & tax paid	(74.8)	(77.1)	(59.7)	(62.1)	(65.8)
Other	20.0	10.9	(0.6)	(0.6)	(0.6)
Operating cash flow	**120.3**	**121.9**	**125.7**	**154.5**	**165.0**
Capital expenditure	(31.1)	(44.7)	(30.9)	(31.7)	(32.3)
(Acquisitions)/divestments	8.1	20.2	0	0	0
Other	0	(6.8)	(6.8)	(6.8)	(6.8)
Funding available/(required)	**97.3**	**90.6**	**88.0**	**116.0**	**126.0**
Dividends paid	(190.4)	(156.7)	(97.0)	(106.4)	(108.0)
Equity raised/(returned)	(1)	(1)	0	0	0
(Increase)/decrease in net debt	**(94.5)**	**(67.4)**	**(9.0)**	**9.6**	**18.0**

Operating Performance	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
NZ electricity revenue	861	804	751	779	789
Gas revenue	29	30	32	34	35
Telecommunication revenue	88	98	98	107	115
Other revenue	52	58	56	52	53
Total revenue	**1,030**	**990**	**937**	**972**	**992**
Generation (GWh)	1,995	1,758	1,852	1,896	1,896
NZ GWAP ($/MWh)	125	107	71	76	74
Mass market sales (GWh)	1,845	1,817	1,822	1,813	1,804
TOU sales (GWh)	880	826	786	821	825
Spot sales (GWh)	1,021	972	919	965	969
Total Sales (GWh)	**3,746**	**3,615**	**3,527**	**3,599**	**3,597**
LWAP ($/MWh)	131	109	76	81	79
LWAP/GWAP	1.04	1.01	1.08	1.07	1.07
Electricity customers (000)	267	266	265	263	262
Usage/customer (MWh)	6.8	6.8	6.9	6.9	6.9
Revenue/MWh sold ($)	230	222	213	216	219
Gas customers (000)	39	41	42	43	44
Volume/customer (GJ)	26.5	24.9	24.9	24.9	24.9
Telco customers (000)	96	104	111	116	120
Revenue/customer ($)	963	983	1,003	1,013	1,023

Balance Sheet (NZ$m)	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
Working capital	(0.3)	(8.2)	15.1	16.7	17.8
Fixed assets	1,924.7	1,836.4	1,828.5	1,820.9	1,813.2
Intangibles	37.0	38.7	37.7	37.4	37.7
Right of use asset	0	35.5	35.5	35.5	35.5
Other assets	114.8	100.2	90.3	80.7	70.7
Total funds employed	**2,076.2**	**2,002.6**	**2,007.1**	**1,991.2**	**1,974.9**
Net debt/(cash)	557.4	616.7	625.7	616.1	598.1
Lease liability	0	36.1	36.1	36.1	36.1
Other liabilities	269.8	249.8	251.9	253.2	253.8
Shareholder's funds	1,224.4	1,076.2	1,067.1	1,056.7	1,055.1
Minority interests	24.6	23.8	26.4	29.1	31.8
Total funding sources	**2,076.2**	**2,002.6**	**2,007.1**	**1,991.2**	**1,974.9**

FY20 result summary

Figure 1. FY20 result summary

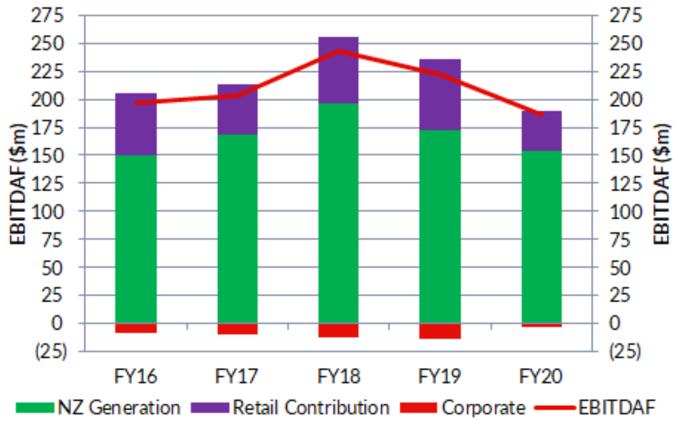
NZ$m	FY19	FY20	Change	Forsyth Barr	Diff	Commentary
Electricity	861	804	-7%	803	1	Decline vs. pcp due to lower wholesale electricity price in FY20
Other	169	186	10%	172	13	Increase due to telco sales, which were also ahead of our forecasts
Total Revenue	**1,030**	**990**	**-4%**	**976**	**14**	
Costs	(808)	(803)	-1%	(789)	(15)	Biggest rises vs. FY19 are in metering, telco cost of sales, staff costs & bad debts
EBITDAF	**222**	**186**	**-16%**	**187**	**0**	In line with expectations, but IFRS15/16 means an effective -$4m miss
Depreciation and amortisation	(47)	(43)	-10%	(39)	(3)	Up on expectation due to IFRS lease depreciation
EBIT	**175**	**144**	**-18%**	**147**	**(4)**	
Fair Value Gains/(Losses)	(6)	16		(12)	28	Fair value movements are not forecast — big gain in 2H20 vs. loss in 1H20
One-off items	(11)	9		(2)	11	$7.5m asset impairment offset by $16.4m gain on sale of metering business
Net interest	(28)	(32)		(35)	3	Includes lease interest expense for first time
Pretax Profit	**130**	**137**	**5%**	**98**	**39**	
Tax	(38)	(40)	6%	(29)	(10)	
Reported NPAT	**93**	**98**	**5%**	**69**	**29**	
Minority interests	(2)	(3)		(2)		
NPAT attributable to s/holders	**91**	**95**	**5%**	**67**	**28**	
Abnormal items	12	(20)		11	(30)	Big reversal in fair value movements in 2H20 the main difference vs. forecast
Normalised NPAT	**103**	**75**	**-26%**	**78**	**(2)**	Overall NPAT in line with forecast, but well down on pcp
Earnings per share (cps)	32.8	24.1	-26%	24.8	(0.7)	
Final ordinary dividend (cps)	17.0	15.5		17.0	(1.5)	Slightly more conservative dividend from TPW
Ordinary div per share (cps)	34.0	32.5	-4%	34.0	(1.5)	
NZ generation (GWh)	1,995	1,758	-12%	1,758	0	Generation volumes well down on pcp a signficant factor in lower earnings
FPVV electricity sold (GWh)	2,729	2,725	0%	2,725	0	

Source: TPW, Forsyth Barr analysis

Key points:

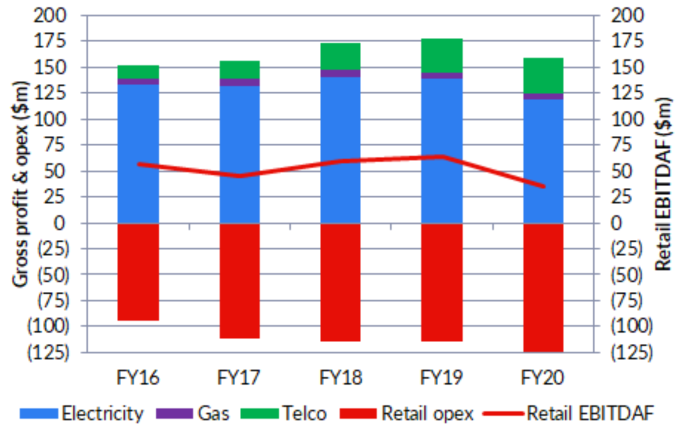
- FY20 was a challenging year for TPW, as evidenced by the -16% (-$36m) in EBITDAF (-20%, -$44m excl IFRS 16 benefit). Both generation and retail segments were down with the key factors behind the weaker performance being:
  - Lower generation volumes (down -12%) and lower wholesale electricity prices (down -9%, we estimate -$16m)
  - Sale of metering business (-$6m headwind)
  - Reduction in avoided cost of transmission (ACOT) revenue (-$7m, this is the last year of reductions)
  - Unplanned Highbank generation station outage (-$6m headwind from lost revenue and repair costs)
  - Increased customer acquisition costs (-$7m impact on EBITDAF) and increased technology costs (-$7m)
- The main bright point was the continued increase in telco gross profit, up +$2m (+5%)
- The operating result was largely in line with expectation, although the adoption of IFRS16 and IFRS15 related movements meant it was slightly worse (-$4m) than anticipated
- There was a big swing in fair value movements between 1H and 2H. Fair value movements are non-cash and are backed-out when calculating underlying earnings; hence, we do not attempt to forecast them
- The sale of TPW's legacy metering business gave rise to a +$16.4m gain on sale
- TPW has revalued its generation assets down -$85.8m, -$7.5m of which has gone through the P&L. The remainder is a reduction in the revaluation reserve. Impacting the valuation is the assumption that ACOT revenue will fall a further ~-45% from FY25 onwards based on assessment of the proposed transmission pricing reform proposals. Whilst TPW contends the impact will be less, it has adopted the independent valuer's view
- Underlying NPAT was down -26% (-$28m) due to the weaker operating result
- TPW declared a final (fully imputed) dividend of 15.5cps (FY20 dividend of 32.5cps). Whilst this is -1.5cps lower than last year and our forecast, we had foreshadowed the possibility of a trimmed dividend in our note dated 7 May. TPW has cited the uncertain outlook (due to COVID-19) as the reason for the more conservative dividend. We believe TPW's relatively high gearing has also played a role in the divided cut. That said, relative to other businesses, the dividend reduction is minor and we expect TPW to quickly resume higher dividends if FY21 conditions end up being more benign than feared.

Figure 2. Segmental EBITDAF



Source: TPW, Forsyth Barr analysis

Figure 3. Retail product gross margin and opex



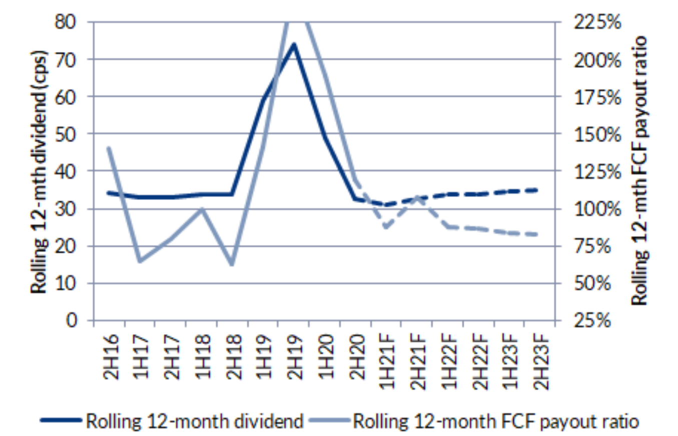
Source: TPW, Forsyth Barr analysis

Forecast/outlook changes

Revised dividend outlook

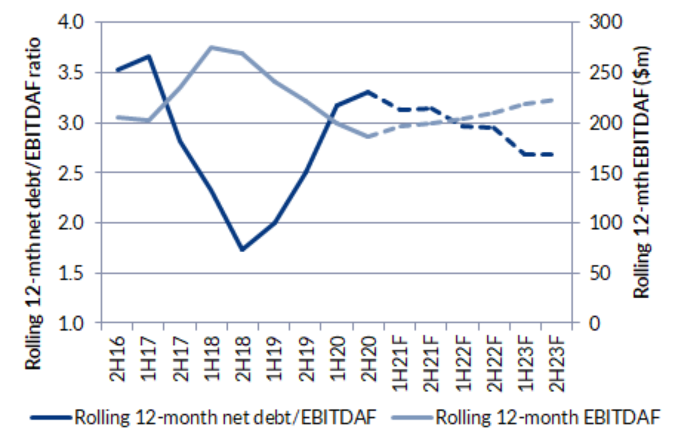
Our revised dividend outlook is not materially different. We assume TPW will again take a cautious approach at the 1H21 result and our forecast is now 15.5cps (down -1.5cps). There is no change outside of that and we assume the 2H21 dividend will be 17.0cps. Whilst there are still many unknowns, early evidence is that COVID-19 is not having a significant impact on the electricity sector. Electricity demand has bounced back (aided by more people working from home, boosting residential demand) and thus far there is no evidence of a bad debt problem.

Figure 4. Rolling 12-month dividend and free cash flow payout



Source: TPW, Forsyth Barr analysis

Figure 5. Rolling 12-month EBITDAF and gearing metric



Source: TPW, Forsyth Barr analysis

FY21 earnings expectations

TPW has guided to FY21 EBITDAF of between $190m and $215m. It is a relatively wide range given the uncertainties relating to COVID-19. Underpinning its guidance range are several assumptions:

- Hydro generation -3% (-55GWh) below average due to the dry North Island conditions
- Commercial consumption to be -35% lower than FY20 due to COVID-19 effects
- Bad debt levels to increase to 3x pre COVID-19 levels

We have lowered our FY21 EBITDAF forecast -$4m to $199m. In our view TPW is overly cautious on commercial sales, with market evidence pointing to a strong rebound. Whilst we have pulled back our commercial sales volumes assumption slightly, that has been offset by a small increase in residential volumes — which TPW has a significant exposure to. Other notable changes are moving to IFRS16, lifting metering costs (as they were higher than expected), trimming our generation assumption -2% and factoring in the lower wholesale price path assumption (since our last update).

Figure 6. Summary forecast changes

	FY21 Old $m	FY21 New $m	Chg %	FY22 Old $m	FY22 New $m	Chg %	FY23 Old $m	FY23 New $m	Chg %
Revenue	937	937	0.0%	973	972	-0.2%	994	992	-0.2%
EBITDAF	**203**	**199**	**-1.7%**	**213**	**209**	**-1.6%**	**225**	**223**	**-1.1%**
EBIT	163	152	-6.6%	172	162	-5.9%	186	175	-5.8%
NPAT (pre-minorities)	91	90	-0.2%	97	99	1.9%	108	109	0.8%
Normalised Profit	**89**	**88**	**-1.3%**	**95**	**96**	**0.9%**	**107**	**106**	**-0.2%**
DPS	**34.0**	**32.5**	**-4.4%**	**34.0**	**34.0**	**0.0%**	**35.0**	**35.0**	**0.0%**
Generation volumes (GWh)	1,896	1,852	-2.3%	1,896	1,896	0.0%	1,896	1,896	0.0%
Electricity Wholesale Price ($/MWh)	$75.0	$73.0	-2.8%	$78.7	$77.1	-2.0%	$77.4	$75.1	-2.9%
Retail sales (GWh)	2,598	2,608	0.4%	2,631	2,634	0.1%	2,625	2,628	0.1%

Source: Forsyth Barr analysis

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Investment Summary

Our rating is OUTPERFORM. Trustpower is trading on undemanding multiples and offers investors an attractive dividend in a sector with stable earnings. The long-term outlook for the sector is positive as New Zealand looks to de-carbonise which will result in higher electricity use.

Business quality

- **Low risk, modest growth industry:** Electricity demand is relatively inelastic and is expected to grow slowly in the future. The industry is well positioned to benefit from New Zealand decarbonising transport and industrial processes.
- **Diversified generation position:** Most of the value within the electricity sector lies within the generation assets. TPW has several small scale hydro generators positioned around New Zealand, creating hydro diversification.
- **Track record:** TPW has focussed on developing a bundled retail strategy, offering telco products alongside its energy products. Whilst retail earnings growth is modest, TPW is reducing churn and the telco product is driving most of its retail earnings growth.

Earnings and cashflow outlook

- **Earnings growth modest and linked to margin growth:** TPW's future earnings growth is modest as it has no large-scale development projects planned in the near-term.
- **Operating cash flow strong but growth likely to be slow:** TPW has a strong track record of returning surplus cash to shareholders. Whilst there is unlikely to be strong ordinary dividend growth, we expect TPW to continue to pay fully imputed dividends.

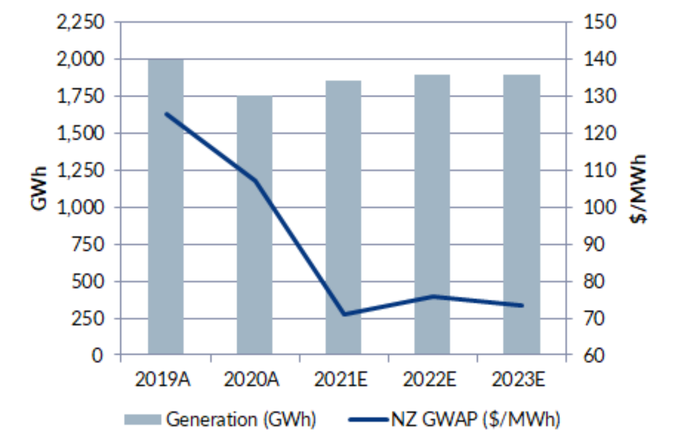
Financial structure

- **Balance sheet:** Following two substantial special dividends paid in FY19, balance sheet headroom is limited, although in our view the balance sheet is not stretched. TPW has no near-term material investments planned.

Risk factors

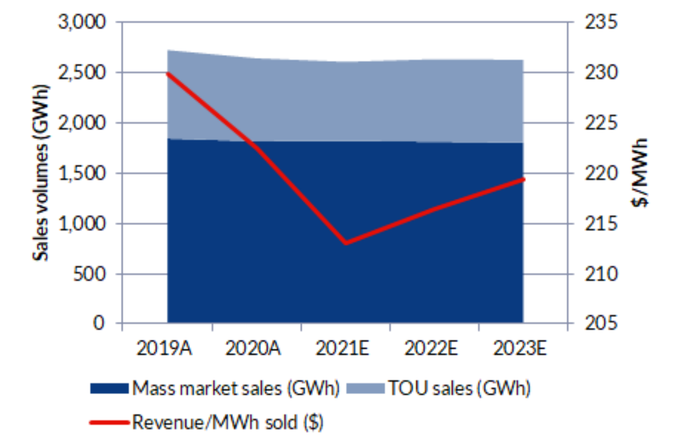
- **NZAS risk:** NZAS has indicated it is undertaking a strategic review, raising the possibility it may close. In our view, the smelter is unlikely to close (less than 10% chance) and TPW will be among the least affected if it does.
- **Rising bond yields:** In recent years TPW has traded in line with bond yields. A lift in interest rates is likely to see TPW trade lower, although in our view interest rates are likely to remain low for the foreseeable future.

Figure 7. Generation volumes and average price sold



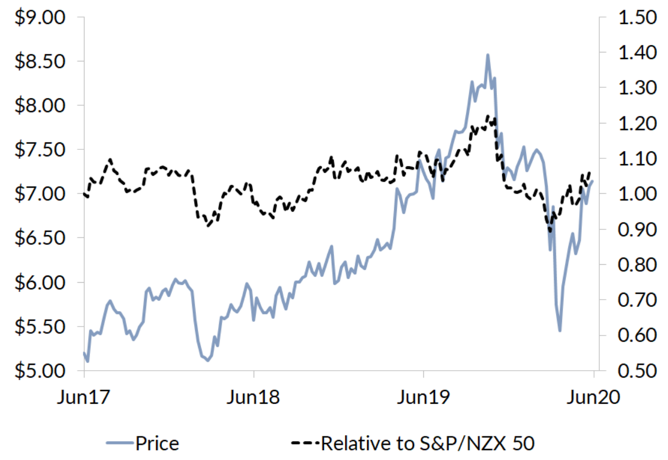
Source: TPW, Forsyth Barr analysis

Figure 8. Retail sales volumes and average selling price



Source: TPW, Forsyth Barr analysis

Figure 9. Price performance



Source: Refinitiv, Forsyth Barr analysis

Figure 10. Substantial shareholders

Shareholder	Latest Holding
Infratil	51.0%
TECT Holdings	26.8%

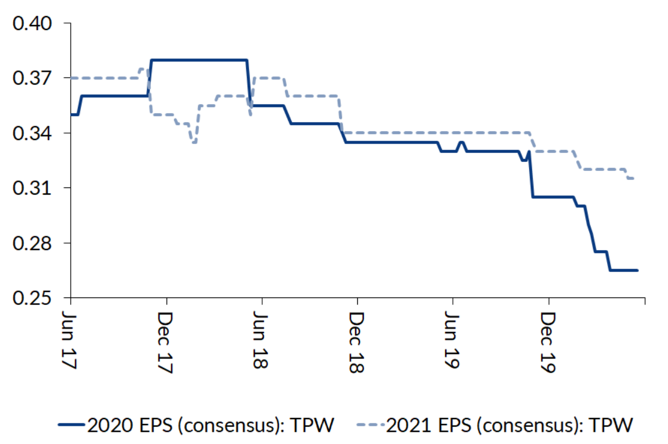
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 11. International valuation comparisons

Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash Yld
(metrics re-weighted to reflect TPW's balance date - March)			(m)	2021E	2022E	2021E	2022E	2021E	2022E	2022E
Trustpower	**TPW NZ**	**NZ$7.14**	**NZ$2,235**	**23.8x**	**22.0x**	**14.3x**	**13.6x**	**18.7x**	**17.6x**	**4.8%**
Contact Energy *	CEN NZ	NZ$6.21	NZ$4,459	18.6x	17.9x	11.8x	11.4x	23.1x	22.7x	6.3%
Genesis Energy *	GNE NZ	NZ$2.85	NZ$2,957	16.0x	13.4x	10.7x	9.9x	26.5x	23.4x	6.2%
Meridian Energy *	MEL NZ	NZ$4.88	NZ$12,494	27.3x	27.7x	17.1x	17.2x	27.7x	27.7x	4.4%
Mercury *	MCY NZ	NZ$4.81	NZ$6,546	25.7x	23.8x	15.0x	14.3x	25.4x	23.6x	3.7%
AGL ENERGY	AGL AT	A$16.36	A$10,250	12.8x	14.1x	6.4x	6.7x	10.1x	11.2x	5.3%
ORIGIN ENERGY	ORG AT	A$5.42	A$9,546	17.5x	15.9x	6.1x	5.9x	19.7x	18.4x	4.5%
			Compco Average:	**19.7x**	**18.8x**	**11.2x**	**10.9x**	**22.1x**	**21.2x**	**5.1%**
EV = Current Market Cap + Actual Net Debt			**TPW Relative:**	**21%**	**17%**	**28%**	**25%**	**-15%**	**-17%**	**-6%**

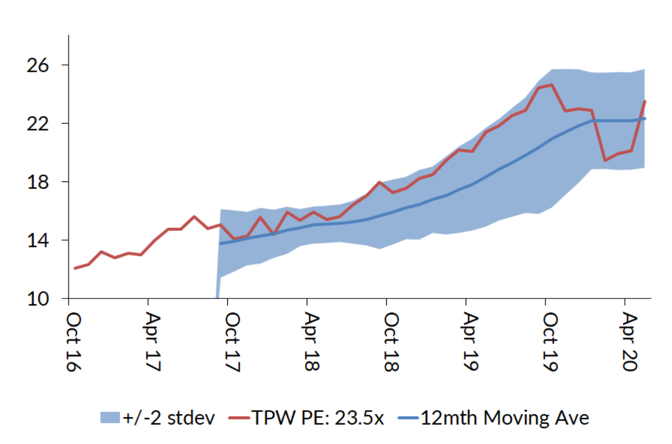
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (TPW) companies fiscal year end

Figure 12. Consensus EPS momentum (NZ$)



Source: Refinitiv, Forsyth Barr analysis

Figure 13. One year forward PE (x)



Source: Refinitiv, Forsyth Barr analysis

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