

# Vector

UNDERPERFORM

## ComCom WACCs Electricity Price

The Commerce Commission (ComCom) has reset Vector's (VCT) maximum allowable electricity revenue -6% lower for the regulatory year to 31 March 2021. The price cut was expected in light of the low interest rate used to set the regulated weighted average cost of capital (WACC). Looking ahead, the key decisions for VCT are what it does with its dividend and whether it applies for a customised price path (CPP).

### What's changed?

- **Earnings:** No change to near-term earnings
- **Target Price:** Unchanged at \$3.20
- **Rating:** UNDERPERFORM rating retained

### ComCom regulatory price reset in line with expectations

The ComCom's starting price point for VCT's regulated electricity revenue is slightly lower than the ComCom's draft September 2019 calculation, with the main difference coming from a lower regulatory opex and capital allowance. The key point is that revenue will be ~\$25m lower in the year to 31 March 2021 relative to the prior year — in line with expectations.

### VCT Board yet to determine dividend implications, CPP possible

VCT has again indicated that the Board "will review its dividend policy and approach to capital projects". At the latest, an announcement regarding dividend policy will be made at VCT's 1H20 result in February 2020.

Our assumption is that the Board will maintain dividend growth of +0.25cps per annum, but will move to partially impute the dividend to 70%. If the Board does not alter the dividend policy it risks a credit rating downgrade to BBB- as its credit metrics get very close to S&P's lower threshold boundary.

VCT has other decisions to make around whether it applies for a CPP and/or increase its up front capital contribution requirements from developers. VCT had been seeking a material increase to its capex allowance, however, the ComCom caps any capex allowance increase at +20% — meaning VCT's capex allowance is -\$189m (~-\$38m per annum) below what VCT had been seeking. Applying for a CPP would allow VCT to seek a higher capex allowance, but comes with significant downside in the form of management distraction and there is no guarantee the ComCom will allow higher capex.

### Potential uplift from higher market risk premium, but in five years

Last week the ComCom released its draft regulatory decision for fibre. In it, the ComCom's WACC advisor recalculated the market risk premium (MRP), increasing his estimate to 7.5% from 7.0%. The electricity price reset uses the current MRP estimate of 7.0%, hence, there is upside potential at the next regulatory price reset (in five years). A 7.5% MRP adds ~+0.18% to VCT's WACC (~+\$10m to EBITDA). However, the draft fibre decision is undergoing consultation. There is a risk the draft decision does not stick, and/or when input methodologies are reset (in three years), the MRP estimate drops back to 7.0%.

### Investment View

Our rating is UNDERPERFORM. Whilst VCT offers a solid dividend yield there is some downside risk to the gross dividend from low interest rates impacting on the electricity regulatory price reset. At this point in time we prefer other high yielding investments over VCT.

NZX Code	VCT
Share price	NZ\$3.52
Target price	NZ\$3.20
Risk rating	Low
Issued shares	995.8m
Market cap	NZ\$3,505m
Average daily turnover	153.6k (NZ\$550k)

### Share Price Performance



Financials: June	19A	20E	21E	22E
NPAT* (NZ\$m)	129.5	137.6	114.4	112.0
EPS* (NZc)	13.0	13.8	11.5	11.2
EPS growth* (%)	-1.5	6.3	-16.9	-2.1
DPS (NZc)	16.5	16.8	17.0	17.3
Imputation (%)	100	70	70	70

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	10.7	10.8	11.1	10.8
EV/EBIT	18.9	19.6	21.4	20.9
PE	27.1	25.5	30.7	31.3
Price / NTA	3.6	3.7	3.9	n/a
Cash dividend yield (%)	4.7	4.8	4.8	4.9
Gross dividend yield (%)	6.5	6.1	6.1	6.2

\*Historic and forecast numbers based on underlying profits

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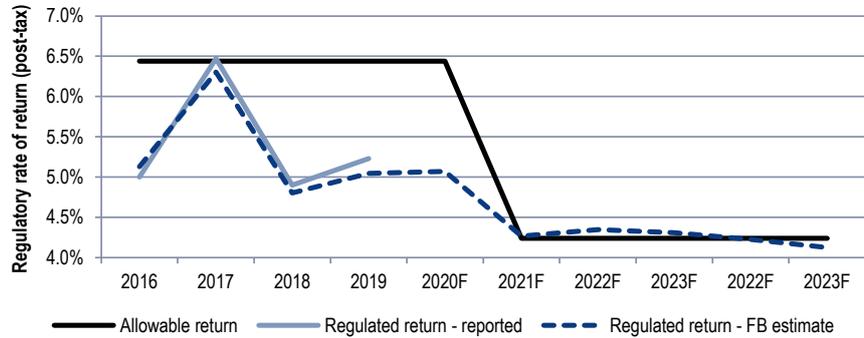
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Vector Limited (VCT)		Priced as at 27 Nov 2019: NZ\$3.52					June year end				
<b>Forsyth Barr valuation</b>						<b>Valuation Ratios</b>					
Valuation methodology						Blend of DCF and dividend growth					
<b>12-month target price (NZ\$)*</b>						<b>2018A 2019A 2020E 2021E 2022E</b>					
<b>3.20</b>						<b>Spot valuations (NZ\$)</b>					
Expected share price return						EV/EBITDA (x)					
Net dividend yield						EV/EBIT (x)					
Estimated 12-month return						PE (x)					
1. DCF						Price/NTA (x)					
2. Dividend growth						Free cash flow yield (%)					
3. n/a						Net dividend yield (%)					
n/a						Gross dividend yield (%)					
<b>Key WACC assumptions</b>						<b>DCF valuation summary (NZ\$m)</b>					
Risk free rate						Total firm value					
Equity beta						(Net debt)/cash					
WACC						Value of equity					
Terminal growth						Shares (m)					
2.00%						5,573					
0.92						2,667					
6.3%						2,906					
1.5%						996					
<b>Profit and Loss Account (NZ\$m)</b>						<b>Capital Structure</b>					
<b>2018A 2019A 2020E 2021E 2022E</b>						<b>2018A 2019A 2020E 2021E 2022E</b>					
Sales revenue						Interest cover EBIT (x)					
<b>Normalised EBITDA</b>						Interest cover EBITDA (x)					
Depreciation and amortisation						Net debt/ND+E (%)					
<b>Normalised EBIT</b>						Net debt/EBITDA (x)					
Net interest						2.4 2.4 2.6 2.2 2.1					
Associate income						4.1 4.2 4.6 4.2 4.0					
Tax						4.4 4.7 5.0 5.5 5.8					
Minority interests						<b>Key Ratios</b>					
<b>Normalised NPAT</b>						Return on assets (%)					
Abnormals/other						Return on equity (%)					
<b>Reported NPAT</b>						Return on funds employed (%)					
Normalised EPS (cps)						EBITDA margin (%)					
DPS (cps)						EBIT margin (%)					
13.2 13.0 13.8 11.5 11.2						Capex to sales (%)					
16.3 16.5 16.8 17.0 17.3						Capex to depreciation (%)					
17 (47) - - -						<b>Operational Performance</b>					
<b>148 83 138 114 112</b>						<b>2018A 2019A 2020E 2021E 2022E</b>					
Normalised EPS (cps)						Electricity throughput (GWh)					
DPS (cps)						Electricity connections (000)					
13.2 13.0 13.8 11.5 11.2						Volume/customer (MWh)					
16.3 16.5 16.8 17.0 17.3						Price (\$/MWh)					
6.9 -0.1 2.3 0.2 2.3						Gas distribution (PJ)					
0.9 4.3 3.1 -1.0 2.9						Gas connections (000)					
-6.4 0.8 0.8 -6.3 2.1						Volume/customer (GJ)					
-12.8 -1.5 6.3 -16.9 -2.1						Natural gas sales (PJ)					
-12.8 -1.5 6.3 -16.9 -2.1						Liquid sales (tonnes)					
1.6 1.5 1.5 1.5 1.5						Liquigas tolling (tonnes)					
<b>Growth Rates</b>						Smart meters (000)					
Revenue (%)						Total meters (000)					
EBITDA (%)						Smart meter %					
EBIT (%)						<b>Divisional Revenue (NZ\$m)</b>					
Normalised NPAT (%)						Electricity					
Normalised EPS (%)						Gas Transport					
DPS (%)						Gas Trading					
6.9 -0.1 2.3 0.2 2.3						Technology					
0.9 4.3 3.1 -1.0 2.9						Corporate/Intersegment revenue					
-6.4 0.8 0.8 -6.3 2.1						<b>Total Revenue</b>					
-12.8 -1.5 6.3 -16.9 -2.1						1,311 1,310 1,339 1,342 1,372					
-12.8 -1.5 6.3 -16.9 -2.1						<b>Divisional EBITDA (NZ\$m)</b>					
1.6 1.5 1.5 1.5 1.5						Electricity					
<b>Cash Flow (NZ\$m)</b>						Gas Transport					
<b>2018A 2019A 2020E 2021E 2022E</b>						Gas Trading					
<b>EBITDA</b>						Technology					
Working capital change						Corporate					
Interest & tax paid						<b>Total EBITDA</b>					
Other						Customer contributions					
<b>Operating cash flow</b>						<b>Adjusted EBITDA</b>					
Capital expenditure						470 486 499 495 514					
(Acquisitions)/divestments											
Other											
<b>Funding available/(required)</b>											
Dividends paid											
Equity raised/(returned)											
<b>Increase/(decrease) in net debt</b>											
170 243 256 258 237											
<b>Balance Sheet (NZ\$m)</b>											
<b>2018A 2019A 2020E 2021E 2022E</b>											
Working capital											
Fixed assets											
Intangibles											
Other assets											
<b>Total funds employed</b>											
Net debt/(cash)											
Other non current liabilities											
Shareholder's funds											
Minority interests											
<b>Total funding sources</b>											
5,497 5,729 5,956 6,161 6,339											
2,367 2,773 3,029 3,287 3,523											
672 645 639 638 637											
2,441 2,332 2,307 2,252 2,192											
18 17 20 22 25											
5,497 5,768 5,995 6,199 6,377											

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

## Regulatory rate of return

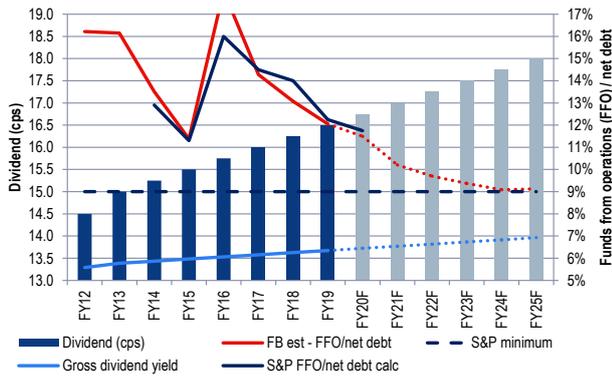
Figure 1. Post-tax regulatory rate of return



Source: VCT, ComCom, Forsyth Barr analysis

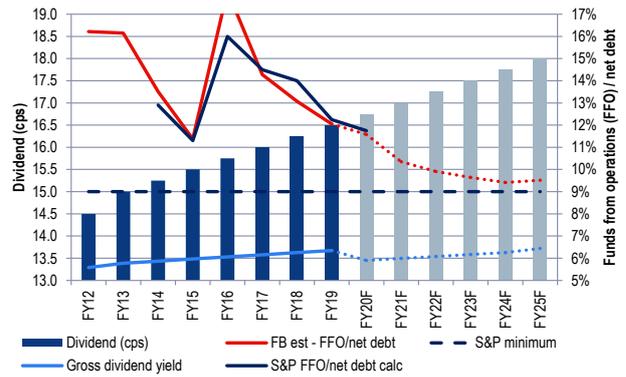
## Credit rating metrics

Figure 2. Dividend, gross yield, credit metrics with 100% imputation



Source: S&P, VCT, Forsyth Barr analysis

Figure 3. Dividend, gross yield, credit metrics with 70% imputation



Source: S&P, VCT, Forsyth Barr analysis

## Investment summary

Our rating is **UNDERPERFORM**. Whilst Vector (VCT) offers a solid dividend yield there is some downside risk to the gross dividend from low interest rates impacting on the electricity regulatory price reset. At this point in time we prefer other high yielding investments over VCT.

### Business quality

- **Regulation:** ~75% of VCT's EBITDA earnings are regulated by the ComCom; hence, the regulatory settings are VCT's key value driver. The nature of regulated earnings is generally stable and predictable earnings.
- **Interest rates:** Within the current regulatory settings the most important factor impacting earnings is the regulatory WACC and within that, interest rates. The next price reset takes effect from April 2020.

### Earnings and cash flow outlook

- **Electricity price reset:** The ComCom has cut VCT's regulatory revenue -6%, with the low interest rate environment being the key contributing factor to the price cut. VCT's Board is reviewing its dividend policy in light of the decision and our base assumption is that it will reduce imputation levels to 70% from 100%.
- **Smart meter roll-out:** VCT is the number one provider of smart meters in New Zealand with its AMS brand. The smart meter roll-out has been a major source of earnings growth and will continue to be until FY19.
- **New energy businesses:** VCT acquired a solar business (PowerSmart), and a home products business (E-Co Products operating under the HRV, EES, and HVACHero brands) in 2017. To date the businesses have underperformed expectations, leading to an asset write-off in FY19.

### Company description

VCT owns and operates the Auckland electricity distribution network and the Auckland gas distribution network. It has ~560,000 electricity and ~108,000 gas connections. The Networks division provides most (~75%) of VCT's operating earnings which are regulated by the Commerce Commission. Unregulated businesses include a natural gas trading business, LPG business, a share in the Kapuni processing plant, telecommunications business, solar business, HRV ventilation business and metering business. AMS is the largest smart metering business in New Zealand. VCT also owns 60% of Liquigas. VCT's majority shareholder is the Entrust which owns 75%.

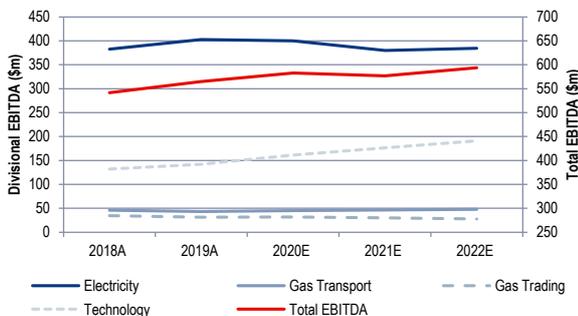
### Financial structure

- **Balance sheet:** Relative to most other listed businesses VCT is highly geared; however, its regulatory earnings provide a high degree of certainty.
- **Capital structure:** VCT is 75% owned by Entrust, constraining VCT's growth options. VCT's requirement to pay slowly increasing dividends limits its investment opportunities to high yielding investments.

### Key risks

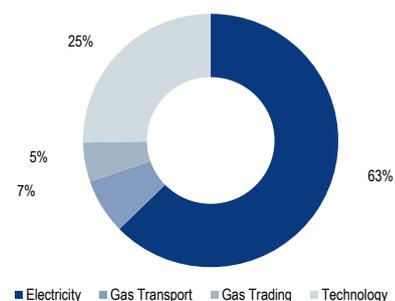
- **Regulation:** Negative regulatory settings are a key earnings risk. We view the current level of risk as medium.
- **Disruptive technology:** Solar roll-out may reduce lines company demand, although any impact is at least 10 years away. VCT is investing in solar and batteries to minimise the threat from new technology.

Figure 4. Divisional EBITDA



Source: VCT, Forsyth Barr analysis

Figure 5. Divisional EBITDA split (FY20)



Source: Forsyth Barr analysis

Figure 6. Substantial Shareholders

Shareholder	Latest Holding
Entrust	75.1%

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

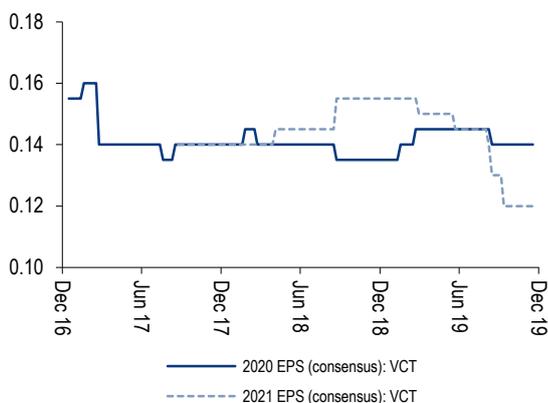
Figure 7. International Compcos

Company	Code	Price	Mkt Cap (m)	PE		EV/EBITDA		EV/EBIT		Cash D/Yld
				2020E	2021E	2020E	2021E	2020E	2021E	2021E
<b>Vector</b>	<b>VCT NZ</b>	<b>NZ\$3.52</b>	<b>NZ\$3,505</b>	<b>25.5x</b>	<b>30.7x</b>	<b>10.6x</b>	<b>10.7x</b>	<b>19.2x</b>	<b>20.5x</b>	<b>4.8%</b>
APA Group	APA AT	A\$10.98	A\$12,955	37.6x	34.1x	13.6x	13.3x	21.9x	21.1x	4.8%
AusNet Services	AST AT	A\$1.74	A\$6,420	23.8x	23.8x	12.5x	12.2x	20.7x	19.9x	6.1%
Spark Infrastructure Group	SKI AT	A\$2.14	A\$3,636	28.8x	40.6x	13.7x	17.2x	14.8x	18.1x	6.6%
<b>Compcos Average:</b>				<b>30.1x</b>	<b>32.9x</b>	<b>13.3x</b>	<b>14.2x</b>	<b>19.1x</b>	<b>19.7x</b>	<b>5.8%</b>
<b>VCT Relative:</b>				<b>-15%</b>	<b>-7%</b>	<b>-20%</b>	<b>-25%</b>	<b>+1%</b>	<b>+4%</b>	<b>-17%</b>

EV = Current Market Cap + Actual Net Debt

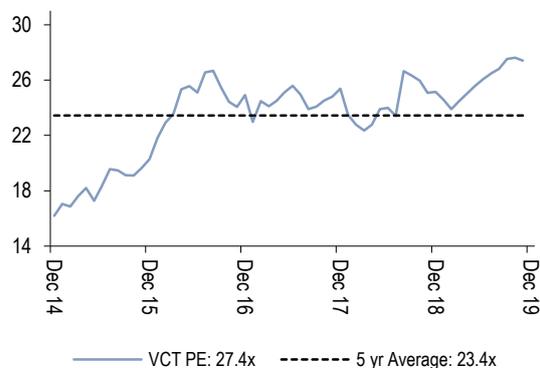
Source: \*Forsyth Barr analysis, Bloomberg Consensus, Compcos metrics re-weighted to reflect headline (VCT) companies fiscal year end

Figure 8. Consensus EPS Momentum



Source: Forsyth Barr analysis, Bloomberg

Figure 9. 12 Month Forward PE



Source: Forsyth Barr analysis

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