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Vector
Divining the Dividend Policy — 1H20 Preview

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UNDERPERFORM

We are expecting Vector (VCT) to reveal a revised dividend policy at its 1H20 result on Tuesday 25 February. VCT has steadily grown its fully imputed dividend following its NGC takeover in 2004. But we believe the fully imputed dividend is about to come to an end, with VCT dropping imputation levels to ~70%. In our view, following the regulatory electricity price cut, which takes effect on 1 April 2020, constantly growing its fully imputed dividend is no longer sustainable. For investors who value imputation credits, dropping the imputation level to 70% is the equivalent of an -8.4% cut in the gross dividend.

NZX Code	VCT
Share price	NZ$3.47
Target price	NZ$3.20
Risk rating	Low
Issued shares	995.8m
Market cap	NZ$3,455m
Avg daily turnover	159.1k (NZ$576k)

Financials: Jun/	19A	20E	21E	22E
NPAT* (NZ$m)	129.5	135.5	114.3	112.2
EPS* (NZc)	13.0	13.6	11.5	11.3
EPS growth* (%)	-1.5	4.6	-15.6	-1.9
DPS (NZc)	16.5	16.8	17.0	17.3
Imputation (%)	100	70	70	70
*Based on normalised profits				

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	10.6	10.8	11.1	10.8
EV/EBIT	18.8	19.6	21.2	20.8
PE	26.7	25.5	30.2	30.8
Price / NTA	3.5	3.6	3.9	4.1
Cash div yld (%)	4.8	4.8	4.9	5.0
Gross div yld (%)	6.6	6.1	6.2	6.3

1H20 result — what we're expecting

- **1H20 result date:** Tuesday 25 February
- **1H20 EBITDA:** $263m (up +1% from $259m in the pcp, excl capital contributions)
- **1H20 EPS:** 8.4cps (up +8% from 7.7% in the pcp)
- **1H20 dividend:** 8.25cps, 70% imputed (1H19 dividend was 8.25cps, 100% imputed)

1H20 result expected to be steady

Our 1H20 EBITDA forecast of $263m (pre-capital contributions) is up +1% on the pcp, with the Technology division again expected to lead the way (EBITDA up +8% to $79m). Gas Trading volumes were down in 1H20, hence, we expect a modest decline in the Gas Trading contribution (-$4m to $17m). We are forecasting a largely flat result from the Networks business (up +1% to $195m). The sizeable +8% lift in EPS is driven by a fall in interest costs as high cost debt rolls off.

Dividend policy change likely following negative regulatory price reset

The key focus of the 1H20 result will be VCT's dividend policy. VCT has previously indicated it will be updating the market on its dividend policy following the electricity price reset that was announced in late November 2019. VCT's current dividend policy has resulted in a steady +0.25cps or +0.5cps increase in the fully imputed annual dividend for the past 10 years. However, to maintain a fully imputed dividend, VCT has been prepaying tax for many years, such that prepaid tax on the balance sheet as at 30 June 2019, was $105m. In our view, following the electricity price cut that will come into force on 1 April 2020, VCT's dividend policy is no longer sustainable if VCT wants to maintain its current credit rating. Whilst it has plenty of debt headroom now, that will gradually decline over the coming five years.

We believe VCT is most likely to cut its imputation level to ~70%, from 100% but maintain a gradual ~+0.25cps increase in the cash dividend. This approach enables VCT to pay less tax, gradually reducing its prepaid tax balance and preserving cash. It is also the most tax efficient approach as investors who cannot use imputation credits will see no change to their dividend.

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Vector Limited (VCT)

Priced as at 19 Feb 2020 (NZ$)	**3.47**

12-month target price (NZ$)*	**3.20**
Expected share price return	-7.8%
Net dividend yield	4.9%
Estimated 12-month return	-2.9%

Spot valuations (NZ$)	
1. DCF	2.71
2. Dividend growth	3.33
3. n/a	n/a

Key WACC assumptions	
Risk free rate	2.00%
Equity beta	0.92
WACC	6.4%
Terminal growth	1.5%

DCF valuation summary (NZ$m)	
Total firm value	5,449
(Net debt)/cash	(2,750)
Less: Capitalised operating leases	
Value of equity	2,699

Profit and Loss Account (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Sales revenue	1,311.2	1,309.8	1,322.2	1,326.1	1,357.9
Normalised EBITDA	**541.6**	**565.1**	**578.7**	**573.8**	**590.9**
Depreciation and amortisation	(225.9)	(246.8)	(260.7)	(273.9)	(284.4)
Normalised EBIT	**315.7**	**318.3**	**318.1**	**299.9**	**306.5**
Net interest	(130.7)	(133.3)	(125.7)	(137.1)	(146.8)
Associate income	(1.5)	0.6	0.6	0.6	0.6
Tax	(53.5)	(52.5)	(55.0)	(46.6)	(45.7)
Minority interests	(1.6)	(1.1)	(2.5)	(2.5)	(2.5)
Normalised NPAT	**131.5**	**129.5**	**135.5**	**114.3**	**112.2**
Abnormals/other	16.7	(46.6)	0	0	0
Reported NPAT	**148.2**	**82.9**	**135.5**	**114.3**	**112.2**
Normalised EPS (cps)	13.2	13.0	13.6	11.5	11.3
DPS (cps)	16.3	16.5	16.8	17.0	17.3

Valuation Ratios	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EV/EBITDA (x)	10.6	10.6	10.8	11.1	10.8
EV/EBIT (x)	18.2	18.8	19.6	21.2	20.8
PE (x)	26.3	26.7	25.5	30.2	30.8
Price/NTA (x)	3.3	3.5	3.6	3.9	4.1
Free cash flow yield (%)	0.1	-2.0	-2.3	-2.5	-1.9
Net dividend yield (%)	4.7	4.8	4.8	4.9	5.0
Gross dividend yield (%)	6.5	6.6	6.1	6.2	6.3

Capital Structure	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Interest cover EBIT (x)	2.4	2.4	2.5	2.2	2.1
Interest cover EBITDA (x)	4.1	4.2	4.6	4.2	4.0
Net debt/ND+E (%)	49.4	53.4	55.8	58.5	60.9
Net debt/EBITDA (x)	4.4	4.7	5.0	5.5	5.8

Growth Rates	**2018A**	**2019A**	**2020A**	**2021A**	**2022A**
Revenue (%)	6.9	-0.1	0.9	0.3	2.4
EBITDA (%)	0.9	4.3	2.4	-0.9	3.0
EBIT (%)	-6.4	0.8	-0.1	-5.7	2.2
Normalised NPAT (%)	-12.8	-1.5	4.6	-15.6	-1.9
Normalised EPS (%)	-12.8	-1.5	4.6	-15.6	-1.9
Ordinary DPS (%)	1.6	1.5	1.5	1.5	1.5

Key Ratios	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Return on assets (%)	5.4	5.3	5.0	4.6	4.6
Return on equity (%)	5.4	5.6	5.9	5.1	5.1
Return on funds employed (%)	4.7	4.5	4.3	3.9	3.9
EBITDA margin (%)	41.3	43.1	43.8	43.3	43.5
EBIT margin (%)	24.1	24.3	24.1	22.6	22.6
Capex to sales (%)	29.5	31.9	38.0	36.0	33.9
Capex to depreciation (%)	171	170	193	174	162
Imputation (%)	100	100	70	70	70
Pay-out ratio (%)	123	127	123	148	153

Cash Flow (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EBITDA	**541.6**	**565.1**	**578.7**	**573.8**	**590.9**
Working capital change	(9.5)	(30.8)	26.4	1.5	(3.3)
Interest & tax paid	(186.3)	(203.1)	(182.3)	(184.7)	(193.1)
Other	44.1	16.9	0	0	0
Operating cash flow	**389.9**	**348.1**	**422.8**	**390.6**	**394.5**
Capital expenditure	(386.8)	(418.4)	(501.9)	(477.3)	(459.8)
(Acquisitions)/divestments	(8.9)	(7.4)	0	0	0
Other	0	(1.6)	0	0	0
Funding available/(required)	**(5.8)**	**(79.3)**	**(79.1)**	**(86.7)**	**(65.3)**
Dividends paid	(163.9)	(164.1)	(166.9)	(169.3)	(171.8)
Equity raised/(returned)	0	0	0	0	0
(Increase)/decrease in net debt	**(169.7)**	**(243.4)**	**(245.9)**	**(256.0)**	**(237.2)**

Operating Performance	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Electricity throughput (GWh)	8,442	8,410	8,446	8,525	8,630
Electricity connections (000)	563	571	579	587	595
Volume/customer (MWh)	15.1	14.8	14.7	14.6	14.6
Price ($/MWh)	49.6	50.4	49.2	47.2	48.0
Gas distribution (PJ)	14.5	14.4	14.8	14.9	15.2
Gas connections (000)	109	112	113	115	117
Volume/customer (GJ)	134	130	131	131	131
Natural gas sales (PJ)	18.3	16.1	15.0	14.7	14.4
Liquid sales (000 tonnes)	77.7	79.2	79.7	80.6	80.6
Liquigas tolling (000 tonnes)	184	152	105	103	101
Smart meters (000)	1,406	1,558	1,730	1,903	2,055
Total meters (000)	1,730	1,875	2,040	2,207	2,353
Smart meter %	81.3	83.1	84.8	86.2	87.3

Balance Sheet (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Working capital	23.6	54.4	28.0	26.6	29.9
Fixed assets	3,995.7	4,184.6	4,425.8	4,629.2	4,804.6
Intangibles	1,397.2	1,354.9	1,354.9	1,354.9	1,354.9
Right of use asset	0	38.1	38.1	38.1	38.1
Other assets	80.7	135.5	136.1	136.7	137.4
Total funds employed	**5,497.3**	**5,767.5**	**5,983.0**	**6,185.5**	**6,364.8**
Net debt/(cash)	2,367.4	2,773.3	3,019.2	3,275.3	3,512.4
Lease liability	0	0	0	0	0
Other liabilities	671.9	644.8	639.1	638.2	637.5
Shareholder's funds	2,440.5	2,332.4	2,305.1	2,250.0	2,190.4
Minority interests	17.5	17.0	19.5	22.0	24.5
Total funding sources	**5,497.3**	**5,767.5**	**5,983.0**	**6,185.5**	**6,364.8**

Divisional EBITDA (NZ$m)					
Electricity	383	403	400	380	384
Gas Transport	46	43	45	47	48
Gas Trading	34	31	30	29	27
Technology	132	142	159	175	189
Corporate	(53.4)	(54.5)	(55.6)	(56.3)	(57.1)
Total EBITDA	**542**	**565**	**579**	**574**	**591**
Customer contributions	72	79	84	82	80
Adjusted EBITDA	**470**	**486**	**495**	**492**	**511**

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

Summary 1H20 forecast

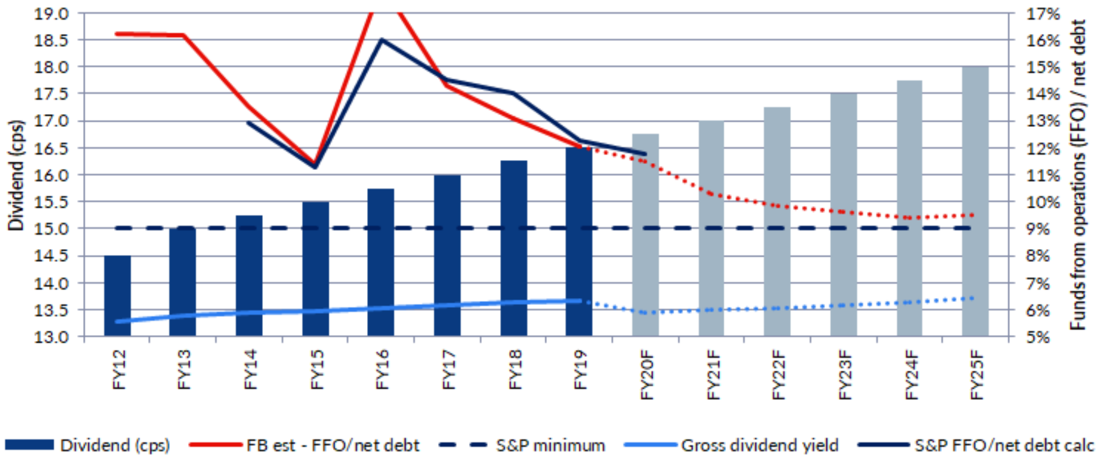
Figure 1. Summary 1H20 forecast

6 months ending 31 December ($m)	1H19	1H20E	% Chg
Total Revenue	**678**	**677**	**0%**
Total Costs	(377)	(371)	-2%
EBITDA			
Electricity & Gas	193	195	1%
Gas Trading	21	17	-17%
Technology	73	79	8%
Corporate/other	(28)	(28)	1%
Adjusted EBITDA	**259**	**263**	**1%**
Capital contributions	41	43	5%
Group EBITDA	**300**	**306**	**2%**
Depreciation & amortisation	120	129	7%
EBIT	**180**	**177**	**-2%**
FV of chg in fin. instruments	(0)	-	
Equity Earnings	1	0	
Net Interest	(72)	(60)	-16%
Pretax	**109**	**118**	**8%**
Tax expense/(benefit)	31	34	7%
NPAT	**78**	**84**	**8%**
Minority interests	(1)	(1)	43%
REPORTED PROFIT	**77**	**83**	**8%**
Normalised EPS (cps)	7.7	8.4	8%
Dividend per share (cps)	8.25	8.25	0%

Source: VCT, Forsyth Barr analysis

Dividend and FFO/net debt with change to 70% imputation

Figure 2. Dividend and FFO/net debt ratio



Source: VCT, Forsyth Barr analysis

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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 cashflow 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 and is now rolling-out meters in Australia. The smart meter roll-out has been a major source of earnings growth and will continue to be for several years.
- **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.

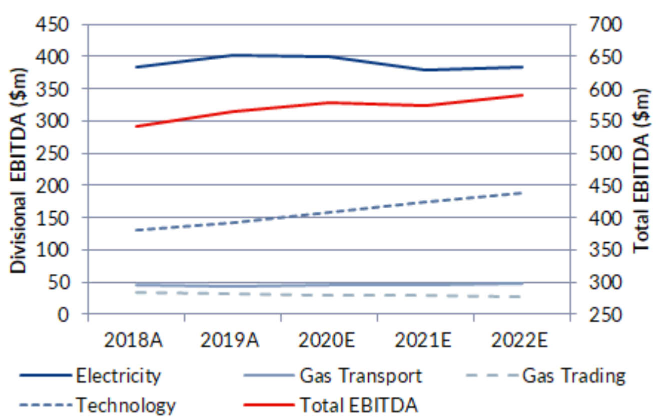
Financial structure

- **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.

Risk factors

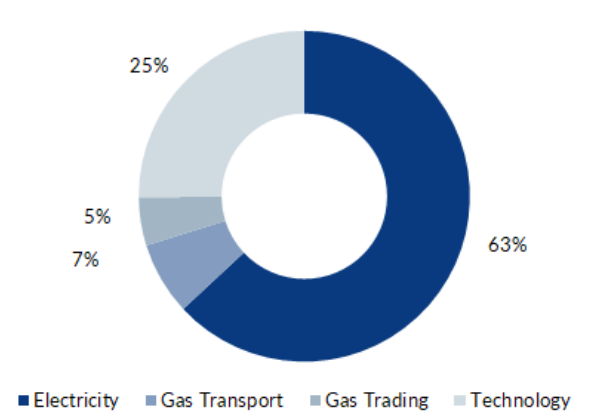
- **Regulation:** Negative regulatory settings are a key earnings risk. We view the current level of risk as medium.
- **Disruptive technology:** Solar roll-out may reduce lines company demand, although any impact is at least 10 years away. VCT is investing in solar and batteries to minimise the threat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

Figure 3. Divisional EBITDA



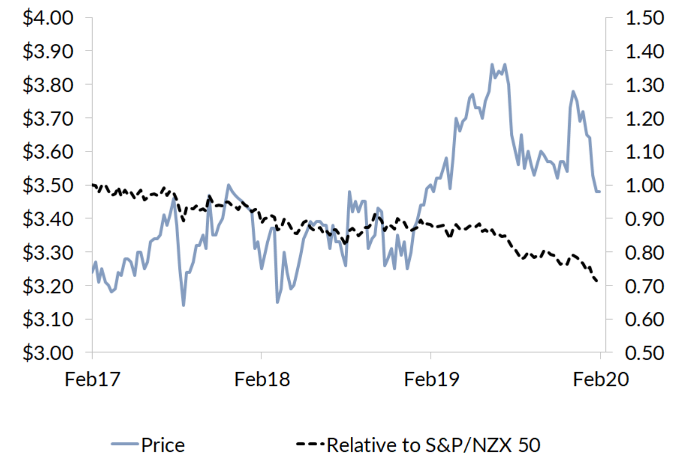
Source: VCT, Forsyth Barr analysis

Figure 4. FY20F EBITDA split



Source: VCT, Forsyth Barr analysis

Figure 5. Price performance



Source: Forsyth Barr analysis

Figure 6. Substantial shareholders

Shareholder	Latest Holding
Entrust	75.1%

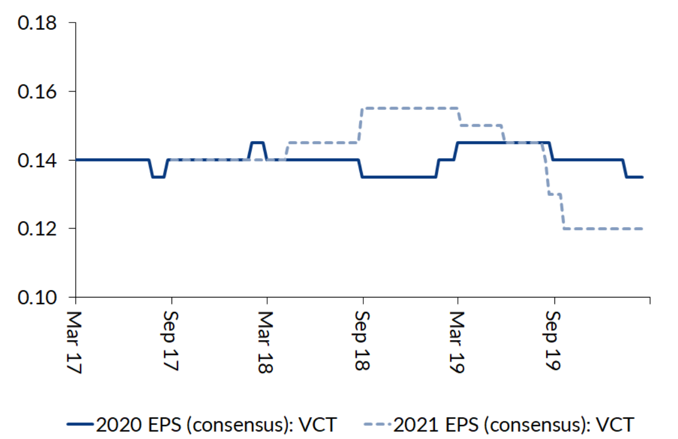
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 7. International valuation comparisons

Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash Yld
(metrics re-weighted to reflect VCT's balance date - June)			(m)	2020E	2021E	2020E	2021E	2020E	2021E	2021E
Vector	**VCT NZ**	**NZ$3.47**	**NZ$3,455**	**25.5x**	**30.2x**	**10.6x**	**10.7x**	**19.2x**	**20.4x**	**4.9%**
APA Group	APA AT	A$11.40	A$13,451	40.4x	36.1x	14.0x	13.6x	22.8x	21.8x	4.6%
AusNet Services	AST AT	A$1.76	A$6,559	23.8x	24.0x	12.6x	12.3x	20.9x	20.3x	6.0%
Spark Infrastructure Group	SKI AT	A$2.15	A$3,653	29.0x	40.6x	10.8x	12.1x	14.4x	17.1x	6.4%
			Compco Average:	**31.1x**	**33.6x**	**12.5x**	**12.7x**	**19.4x**	**19.7x**	**5.7%**
EV = Current Market Cap + Actual Net Debt			**VCT Relative:**	**-18%**	**-10%**	**-15%**	**-16%**	**-1%**	**4%**	**-14%**

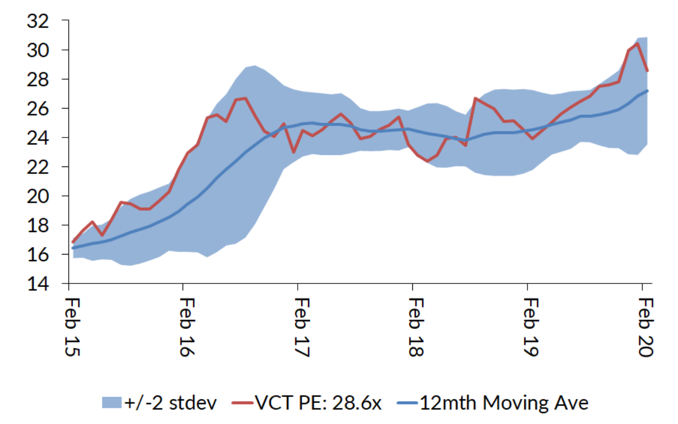
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (VCT) companies fiscal year end

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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