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Vector
Gross Dividend Dives — 1H20 Result Review

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NEUTRAL

Vector's (VCT) directors have chosen a more conservative path with VCT's revised dividend policy than we had been expecting, cutting imputation levels to 30% vs. our forecast of 70%. In addition, the progressive +0.25cps cash dividend increase has been put on hold, pending earnings growth. The combined effect is to cut our gross dividend forecast -13% to 18.4cps. We have cut our target price -20cps to $3.00 in light of the materially lower gross dividend. However, we are lifting our rating to NEUTRAL as VCT's stable earnings profile should provide investors with confidence around the dividend outlook for the coming five years (at least until the next electricity regulatory price reset).

What's changed
- **Rating and target price:** Rating lifted to NEUTRAL from UNDERPERFORM. Target price cut -20cps to $3.00.
- **EBITDA forecast changes:** FY20/FY21/FY22 EBITDA increased +$2m/+$5m/+$7m to $497m/$497m/$518m respectively

NZX Code	VCT
Share price	NZ$3.23
Target price	NZ$3.00
Risk rating	Low
Issued shares	995.8m
Market cap	NZ$3,216m
Avg daily turnover	160.8k (NZ$582k)

Financials: Jun/	19A	20E	21E	22E
NPAT* (NZ$m)	129.5	135.6	121.8	123.1
EPS* (NZc)	13.0	13.6	12.2	12.4
EPS growth* (%)	-1.5	4.7	-10.1	1.0
DPS (NZc)	16.5	16.5	16.5	16.5
Imputation (%)	100	30	30	30
*Based on normalised profits				

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	10.1	10.2	10.4	10.1
EV/EBIT	18.0	18.6	19.6	19.0
PE	24.8	23.7	26.4	26.1
Price / NTA	3.3	3.4	3.5	3.7
Cash div yld (%)	5.1	5.1	5.1	5.1
Gross div yld (%)	7.1	5.7	5.7	5.7

Board takes a more conservative approach on the dividend than expected

True to its word VCT updated its dividend policy following the electricity price reset decision in late 2019. The new policy sees our FY20 cash dividend forecast fall -0.25cps to 16.5cps and lowers imputation levels from 70% to 30%. The decision to partially impute the dividend to 30% equates to a -20% gross dividend cut from a fully imputed dividend. Removing the +0.25cps dividend increase lifts the FY20 gross dividend cut to -21%, -13% more than our -8% forecast heading into the result. The upside of the policy means VCT will have more debt headroom heading into the 2024 electricity price reset, increasing its dividend sustainability.

1H20 result in line with expectations

The 1H20 result came in as expected with pre-capital contribution EBITDA of $264m, +$1m higher than our forecast. Metering (now separated out of the Technology division) had the strongest earnings growth, with EBITDA up +12%. Gas Trading performed well in light of lower volumes, whereas Network EBITDA fell -5% predominantly on higher maintenance costs. Capital contributions remain strong, lifting +9% to $45m. However, a +10% increase in depreciation meant 1H20 NPAT was -$3m lower than the pcp.

Outlook slightly better, but lower dividend impacts on target price

VCT's FY20 EBITDA (pre-capital contributions) guidance is $495m to $505m. We have increased our FY20 EBITDA forecast +$2m to $497m. A better Technology (driven by a stronger Metering contribution) and Gas Trading performance has offset a weaker Networks forecast. The greater clarity on the Metering performance has resulted in a lift in our longer term forecasts. However, the lower gross dividend outlook has more than offset the earnings upside, such that our target price is cut -20cps to $3.00.

Our rating upgrade to NEUTRAL reflects our 12-month view that VCT will perform broadly in line with the market. Whilst we see short-term share price downside risk, there is now more certainty around VCT's dividend (albeit it is lower than previously thought).

Vector Limited (VCT)

Priced as at 25 Feb 2020 (NZ$)	3.23

12-month target price (NZ$)*	3.00
Expected share price return	-7.1%
Net dividend yield	5.1%
Estimated 12-month return	-2.0%

Spot valuations (NZ$)	
1. DCF	2.67
2. Dividend growth	2.99
3. n/a	n/a

Key WACC assumptions	
Risk free rate	2.00%
Equity beta	0.92
WACC	6.7%
Terminal growth	1.5%

DCF valuation summary (NZ$m)	
Total firm value	5,407
(Net debt)/cash	(2,750)
Less: Capitalised operating leases	
Value of equity	2,658

Profit and Loss Account (NZ$m)	2018A	2019A	2020E	2021E	2022E
Sales revenue	1,311.2	1,309.8	1,332.4	1,331.6	1,363.0
Normalised EBITDA	**541.6**	**565.1**	**586.9**	**584.8**	**603.4**
Depreciation and amortisation	(225.9)	(246.8)	(264.4)	(274.2)	(283.0)
Normalised EBIT	**315.7**	**318.3**	**322.5**	**310.7**	**320.3**
Net interest	(130.7)	(133.3)	(128.5)	(136.4)	(144.4)
Associate income	(1.5)	0.6	0.2	0.2	0.2
Tax	(53.5)	(52.5)	(56.2)	(50.6)	(51.1)
Minority interests	(1.6)	(1.1)	(2.0)	(2.0)	(2.0)
Normalised NPAT	**131.5**	**129.5**	**135.6**	**121.8**	**123.1**
Abnormals/other	16.7	(46.6)	0	0	0
Reported NPAT	**148.2**	**82.9**	**135.6**	**121.8**	**123.1**
Normalised EPS (cps)	13.2	13.0	13.6	12.2	12.4
DPS (cps)	16.3	16.5	16.5	16.5	16.5

Valuation Ratios	2018A	2019A	2020E	2021E	2022E
EV/EBITDA (x)	10.2	10.1	10.2	10.4	10.1
EV/EBIT (x)	17.5	18.0	18.6	19.6	19.0
PE (x)	24.5	24.8	23.7	26.4	26.1
Price/NTA (x)	3.1	3.3	3.4	3.5	3.7
Free cash flow yield (%)	0.1	-2.2	-1.5	-1.6	-0.9
Net dividend yield (%)	5.0	5.1	5.1	5.1	5.1
Gross dividend yield (%)	7.0	7.1	5.7	5.7	5.7

Capital Structure	2018A	2019A	2020E	2021E	2022E
Interest cover EBIT (x)	2.4	2.4	2.5	2.3	2.2
Interest cover EBITDA (x)	4.1	4.2	4.6	4.3	4.2
Net debt/ND+E (%)	49.4	53.4	55.6	57.8	59.7
Net debt/EBITDA (x)	4.4	4.7	4.9	5.3	5.5

Growth Rates	2018A	2019A	2020A	2021A	2022A
Revenue (%)	6.9	-0.1	1.7	-0.1	2.4
EBITDA (%)	0.9	4.3	3.9	-0.4	3.2
EBIT (%)	-6.4	0.8	1.3	-3.7	3.1
Normalised NPAT (%)	-12.8	-1.5	4.7	-10.1	1.0
Normalised EPS (%)	-12.8	-1.5	4.7	-10.1	1.0
Ordinary DPS (%)	1.6	1.5	0.0	0.0	0.0

Key Ratios	2018A	2019A	2020E	2021E	2022E
Return on assets (%)	5.4	5.3	5.1	4.8	4.8
Return on equity (%)	5.4	5.6	5.9	5.4	5.5
Return on funds employed (%)	4.7	4.5	4.4	4.1	4.1
EBITDA margin (%)	41.3	43.1	44.1	43.9	44.3
EBIT margin (%)	24.1	24.3	24.2	23.3	23.5
Capex to sales (%)	29.5	31.9	37.8	36.1	34.0
Capex to depreciation (%)	171	170	190	175	164
Imputation (%)	100	100	30	30	30
Pay-out ratio (%)	123	127	121	135	134

Cash Flow (NZ$m)	2018A	2019A	2020E	2021E	2022E
EBITDA	**541.6**	**565.1**	**586.9**	**584.8**	**603.4**
Working capital change	(9.5)	(30.8)	45.7	22.8	20.3
Interest & tax paid	(186.3)	(203.1)	(178.7)	(179.6)	(187.5)
Other	44.1	16.9	0	0	0
Operating cash flow	**389.9**	**348.1**	**454.0**	**428.1**	**436.2**
Capital expenditure	(386.8)	(418.4)	(503.1)	(480.9)	(463.9)
(Acquisitions)/divestments	(8.9)	(7.4)	0	0	0
Other	0	(1.6)	0	0	0
Funding available/(required)	**(5.8)**	**(79.3)**	**(49.2)**	**(52.9)**	**(27.7)**
Dividends paid	(163.9)	(164.1)	(164.4)	(164.4)	(164.4)
Equity raised/(returned)	0	0	0	0	0
(Increase)/decrease in net debt	**(169.7)**	**(243.4)**	**(213.5)**	**(217.2)**	**(192.1)**

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	49.6	49.2	47.1	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	76.3	76.6	76.5
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	8.7	(14.1)	(34.4)
Fixed assets	3,995.7	4,184.6	4,423.4	4,630.1	4,811.0
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	135.7	135.9	136.1
Total funds employed	**5,497.3**	**5,767.5**	**5,960.8**	**6,144.9**	**6,305.7**
Net debt/(cash)	2,367.4	2,773.3	2,986.8	3,204.1	3,396.2
Lease liability	0	0	0	0	0
Other liabilities	671.9	644.8	650.8	658.2	666.2
Shareholder's funds	2,440.5	2,332.4	2,304.1	2,261.6	2,220.4
Minority interests	17.5	17.0	19.0	21.0	23.0
Total funding sources	**5,497.3**	**5,767.5**	**5,960.8**	**6,144.9**	**6,305.7**

Divisional EBITDA (NZ$m)	2018A	2019A	2020E	2021E	2022E
Electricity	383	403	398	385	389
Gas Transport	46	43	45	46	48
Gas Trading	34	31	32	28	25
Metering	132	139	155	169	184
Corporate/Other	(53.4)	(50.90)	(42.8)	(42.7)	(42.8)
Total EBITDA	**542**	**565**	**587**	**585**	**603**
Customer contributions	72	85	90	88	85
Adjusted EBITDA	**470**	**480**	**497**	**497**	**518**

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

Analysing the new dividend policy

How has the dividend policy changed?

"The Board has decided to move from a progressive dividend policy of increasing dividends +0.25 cents per annum, to a policy of maintaining the current dividend of 16.5 cents per annum with the expectation of continuing to increase dividends in the future based on projected growth in Vector's businesses".

Of more importance than the cash dividend, the Board has also decided to no longer prepay tax in order to fully impute the dividend. As at 31 December 2019, VCT had built up a prepaid tax balance of $86m (down from $105m at 30 June 2019). The high level of prepaid tax means VCT didn't have to pay tax for ~two years, although that would also mean no imputation credits.

The Board has decided to partially impute the dividend to 30% which will see the prepaid tax balance gradually reduce over time.

What we had expected

The decision to partially impute the dividend was expected. Our analysis indicated that the old dividend policy would have meant that in ~four years VCT would be in danger of losing its investment grade credit rating. However, we had assumed the Board would take a slightly more aggressive approach that it has. Given VCT's Trust ownership and the Trust's need for gradually growing gross dividends to pay its consumer beneficiaries, we had assumed VCT would target debt levels just above the credit rating downgrade level (with an adequate buffer) at the time of the next electricity price reset decision in 2024. We believed VCT could continue increasing its cash dividend +0.25cps per annum, but cut imputation levels to 70%.

What we are now expecting

Our revised forecast is for a flat cash dividend until FY23, when we expect a resumption in dividend growth. We also expect it will take ~four years for VCT to use its prepaid tax balance, hence, we are now forecasting a 30% imputation level for the next four years. The combined effect is to lower our FY20 gross dividend forecast -13%, increasing to -15% in FY21.

Relative to the old dividend policy of fully imputing a growing dividend, the revised dividend is cutting the gross dividend -21% in FY20, increasing to -22% in FY21.

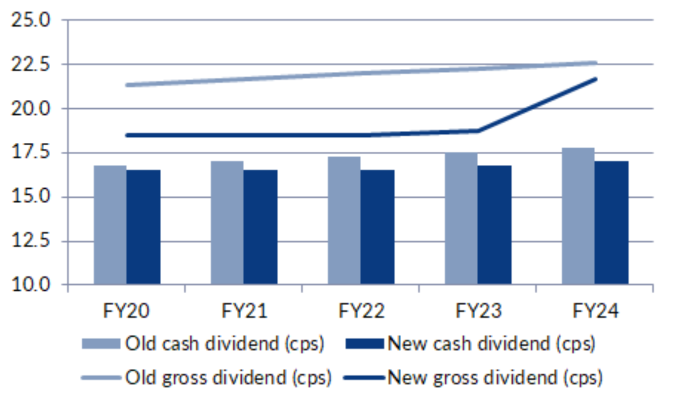
The new dividend policy provides VCT with greater debt headroom ahead of the 2024 electricity price reset decision. We now estimate that the FFO/net debt ratio will remain above 10%, instead of falling to ~9.5% under our old forecast.

Figure 1. Dividend forecast changes

	FY20	FY21	FY22	FY23	FY24
Old cash dividend (cps)	16.75	17.00	17.25	17.50	17.75
New cash dividend (cps)	16.50	16.50	16.50	16.75	17.00
% change	-1%	-3%	-4%	-4%	-4%
Old imputation level	70%	70%	70%	70%	70%
New imputation level	30%	30%	30%	30%	70%
Old gross dividend (cps)	21.31	21.63	21.95	22.26	22.58
New gross dividend (cps)	18.44	18.44	18.44	18.72	21.63
% change	-13%	-15%	-16%	-16%	-4%
Gross dividend under old policy (cps)	23.26	23.61	23.96	24.31	24.65
% change vs. old dividend policy	-21%	-22%	-23%	-23%	-12%

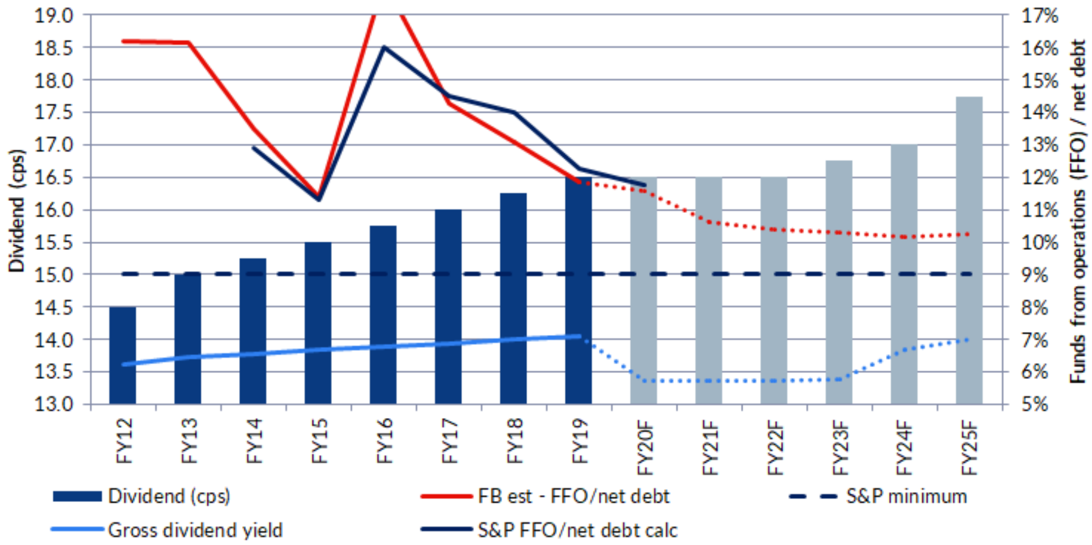
Source: Forsyth Barr analysis

Figure 2. Dividend forecast changes



Source: Forsyth Barr analysis

Figure 3. Estimated FFO/net debt under revised dividend policy



Source: VCT, S&P, Forsyth Barr analysis

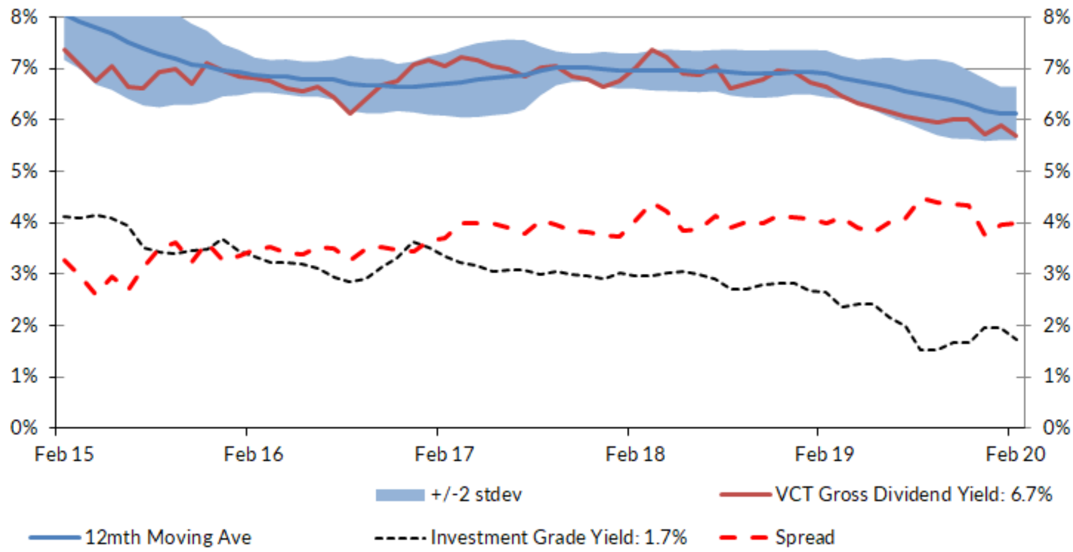
Valuation and target price implications: target price cut -20cps to $3.00

The lower gross dividend outlook has impacted our DCF. Our WACC formulation takes into account the level of imputation credits and the lower than expected imputation levels for the next few years results in our WACC increasing +0.2% to 6.7%. The DCF impact is ~-30cps.

Our target price takes into account our DCF as well as market dividend yield expectations. Prior to VCT's recent share price weakness, VCT had traded down on gross dividend yield of a little over 6.0%. However, the gross dividend cut means it is currently trading on a gross yield of 5.7%.

We have cut our target price -20cps to $3.00. Whilst greater visibility on VCT's metering business has lifted our metering forecasts, (offsetting much of the negative DCF impact from a higher WACC), the greater than expected cut in the gross dividend has been the main catalyst for the -20cps target price cut. A $3.00 share price equates to a gross dividend yield of 6.2%.

Figure 4. Historic gross dividend yield



Source: Eikon, Forsyth Barr analysis

1H20 result analysis and forecast changes

Figure 5. Summary 1H20 result

6 months ending 31 Dec ($m)	1H19	1H20	% Chg	FB	Diff	Commentary
Electricity & Gas	397	400	1%	394	5	
Gas Trading	153	151	-1%	142	9	Solid performance given decline in volumes
Metering	93	102	10%	146	(43)	Metering now broken out of Technology
Corporate/other	43	41	-3%	0	41	Other Technology business (fibre and HRV) now included in "Corporate/other"
Intersegment	(3)	(2)		(5)	2	
Total Revenue	**683**	**692**	**1%**	**677**	**15**	
Total Costs	(377)	(383)	1%	(371)	(11)	
EBITDA						
Electricity & Gas	199	189	-5%	195	(5)	Higher maintenance costs impacted on Electricity earnings
Gas Trading	21	21	0%	17	4	Strong performance, but does include $2m provision release
Metering	68	76	12%	79	(3)	Strong Metering performance offsets weaker regulatory earnings
Corporate/other	(23)	(22)	-5%	(28)	6	
Adjusted EBITDA	**265**	**264**	**0%**	**263**	**2**	Largely in line with expectations
Capital contributions	41	45	9%	43	2	Increase in capital contributions as connection growth continues
Group EBITDA	**306**	**309**	**1%**	**306**	**3**	
Depreciation & amort.	120	131	10%	129	3	Lift in depreciation due to higher asset base, accelerated depn and IFRS 16
EBIT	**186**	**178**	**-4%**	**177**	**1**	
FV movements	(0)	(1)		-	(1)	
Equity earnings	1	0		0	(0)	
Net Interest	(72)	(64)	-11%	(60)	(4)	Includes IFRS 16 interest costs
Pretax	**115**	**114**	**-1%**	**118**	**(4)**	
Tax Expense/(Benefit)	31	33	6%	34	(0)	
NPAT	**83**	**80**	**-4%**	**84**	**(4)**	
Minority Interests	(1)	(1)	14%	(1)	0	
REPORTED PROFIT	**83**	**80**	**-4%**	**83**	**(4)**	
EPS	8.3	8.0	-4%	8.4	(0.4)	
Dividend per share	8.25	8.25	0%	8.25	0.00	Interim dividend as expected, but only 30% imputed

Source: VCT, Forsyth Barr analysis

Figure 6. Forecast changes

$m	FY20 Old	FY20 New	Chg %	FY21 Old	FY21 New	Chg %	FY22 Old	FY22 New	Chg %
Total Revenue	**1,322**	**1,332**	**1%**	**1,326**	**1,332**	**0%**	**1,358**	**1,363**	**0%**
EBITDA									
Networks	362	353	-2%	345	343	-1%	353	351	-1%
Gas Trading	30	32	6%	29	28	-3%	27	25	-4%
Metering	159	155	-2%	175	169	-3%	189	184	-2%
Corporate/other	(56)	(43)	-23%	(56)	(43)	-24%	(57)	(43)	-25%
Adjusted EBITDA	**495**	**497**	**0%**	**492**	**497**	**1%**	**511**	**518**	**1%**
Capital contributions	84	90	7%	82	88	7%	80	85	7%
Group EBITDA	**579**	**587**	**1%**	**574**	**585**	**2%**	**591**	**603**	**2%**
Depreciation	261	264	1%	274	274	0%	284	283	0%
EBIT	**318**	**323**	**1%**	**300**	**311**	**4%**	**306**	**320**	**5%**
Net Interest	(126)	(128)	2%	(137)	(136)	-1%	(147)	(144)	-2%
FV mvmts	-	(1)		-	-		-	-	
Equity Income	1	0	-67%	1	0	-67%	1	0	-67%
Pretax	**193**	**194**	**0%**	**163**	**174**	**7%**	**160**	**176**	**10%**
Tax Expense/(Benefit)	55	56	2%	47	51	9%	46	51	12%
NPAT	**138**	**138**	**0%**	**117**	**124**	**6%**	**115**	**125**	**9%**
Minority Interests	(3)	(2)	-20%	(3)	(2)	-20%	(3)	(2)	-20%
REPORTED PROFIT	**135**	**136**	**0%**	**114**	**122**	**7%**	**112**	**123**	**10%**
Capital expenditure	502	503	0%	477	481	1%	460	464	1%
EPS	13.6	13.6	0%	11.5	12.2	7%	11.3	12.4	10%
Dividend (cps)	16.75	16.50	-1%	17.00	16.50	-3%	17.25	16.50	-4%
Dividend imputation	70%	30%	-57%	70%	30%	-57%	70%	30%	-57%

Source: Forsyth Barr analysis Note: These forecast changes incorporate VCT's revised segmental reporting which separates out Metering from Technology for the first time.

Investment Summary

Our rating is NEUTRAL. VCT's revised dividend policy ensures the dividend is sustainable and there is no longer a risk of the dividend being cut. Whilst FY21 earnings will drop due to lower regulatory electricity prices, the Metering business continues to go from strength to strength and will drive VCT's medium-term earnings growth as it expands in Australia.

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. In response VCT's Board has dropped the progressive dividend policy and will no longer pay a fully imputed dividend. We are forecasting a flat 16.5cps for the next three years, 30% imputed.
- **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 as VCT expands into Australia.
- **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.

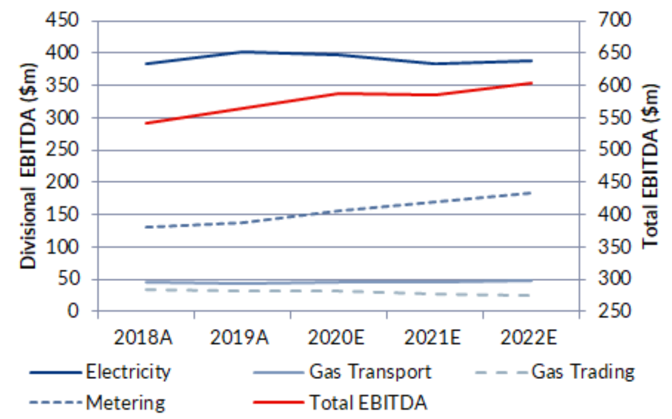
Financial structure

- **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

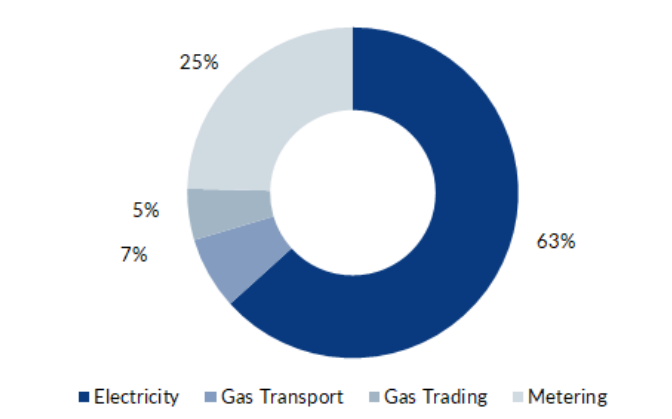
- **Regulation:** Negative regulatory settings are a key earnings risk. We view the current level of risk as medium.
- **Disruptive technology:** Solar roll-out may reduce lines company demand, although any impact is at least 10 years away. VCT is investing in solar and batteries to minimise the threat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

Figure 7. Divisional EBITDA



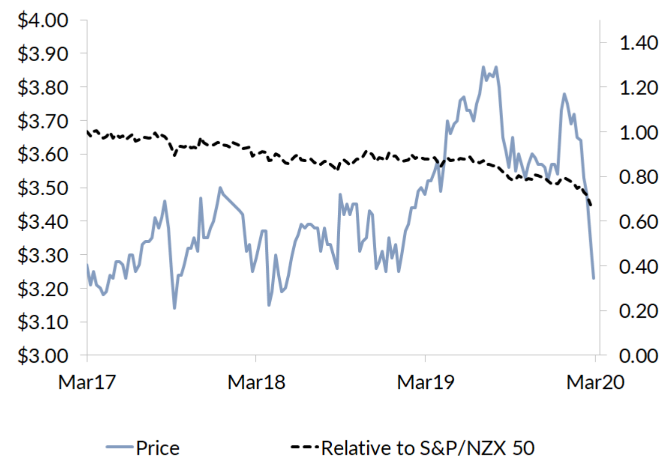
Source: VCT, Forsyth Barr analysis

Figure 8. FY20E EBITDA breakdown



Source: VCT, Forsyth Barr analysis

Figure 9. Price performance



Source: Forsyth Barr analysis

Figure 10. Substantial shareholders

Shareholder	Latest Holding
Entrust	75.1%

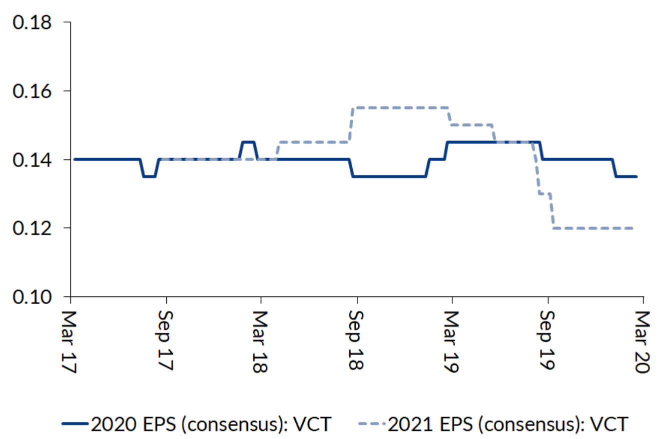
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 11. International valuation comparisons

Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash Yld
(metrics re-weighted to reflect VCT's balance date - June)			(m)	2020E	2021E	2020E	2021E	2020E	2021E	2021E
Vector	**VCT NZ**	**NZ$3.23**	**NZ$3,216**	**23.7x**	**26.4x**	**10.0x**	**10.1x**	**18.2x**	**18.9x**	**5.1%**
APA GROUP	APA AT	A$11.15	A$13,156	39.8x	35.5x	13.9x	13.4x	22.5x	21.5x	4.7%
AUSNET SERVICES	AST AT	A$1.71	A$6,373	23.1x	23.4x	12.5x	12.2x	20.6x	20.0x	6.2%
SPARK INFRASTRUCTURE GROUP	SKI AT	A$2.06	A$3,500	27.8x	38.9x	9.4x	11.7x	13.9x	16.5x	6.6%
			Compco Average:	**30.2x**	**32.6x**	**11.9x**	**12.4x**	**19.0x**	**19.4x**	**5.8%**
EV = Current Market Cap + Actual Net Debt			**VCT Relative:**	**-22%**	**-19%**	**-16%**	**-19%**	**-4%**	**-2%**	**-12%**

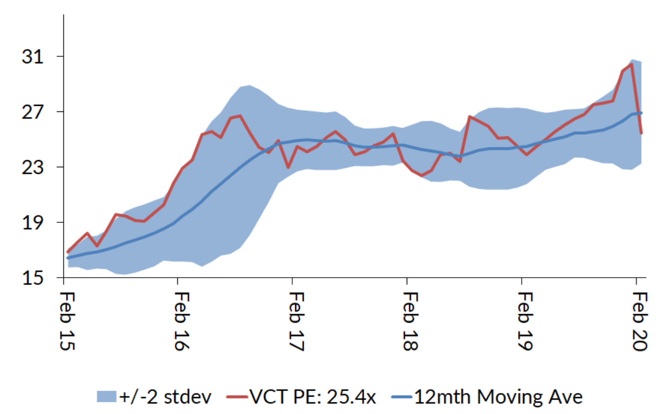
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (VCT) companies fiscal year end

Figure 12. Consensus EPS momentum (NZ$)



Source: Forsyth Barr analysis

Figure 13. One year forward PE (x)



Source: Forsyth Barr analysis

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