

# Vector

## Metering Outpaces Poles – FY20 Result Review

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**NEUTRAL** 

Vector's (VCT) FY20 result is best described as steady with the Metering business continuing to grow strongly, offset by the regulated Network business facing pricing and COVID-19 challenges. FY20 EBITDA (before capital contributions) was NZ\$490m, +NZ\$4m on FY19. VCT's new dividend policy meant the final dividend was flat at 8.25cps and only partially imputed. Whilst there is little change to our forecasts, falling interest rates and cost of capital changes have driven a +48% increase in our target price to NZ\$4.45. However, we retain our NEUTRAL rating as we prefer other high yield stocks at these levels.

NZX Code	VCT	Financials: Jun/	20A	21E	22E	23E	Valuation (x)	20A	21E	22E	23E
Share price	NZ\$4.26	NPAT* (NZ\$m)	118.4	148.9	151.7	158.0	EV/EBITDA	12.1	12.3	12.0	11.5
Target price	NZ\$4.45	EPS* (NZc)	11.9	14.9	15.2	15.9	EV/EBIT	22.3	22.4	22.1	21.2
Risk rating	Low	EPS growth* (%)	1.7	25.7	1.9	4.1	PE	35.8	28.5	28.0	26.9
Issued shares	995.8m	DPS (NZc)	16.5	16.5	16.5	16.8	Price / NTA	4.4	4.5	4.6	4.6
Market cap	NZ\$4,242m	Imputation (%)	30	30	30	30	Cash div yld (%)	3.9	3.9	3.9	3.9
Avg daily turnover	186.9k (NZ\$662k)	*Based on normalised profits					Gross div yld (%)	4.3	4.3	4.3	4.4

### Metering business powers on, but Networks faces resistance

NZ\$490m EBITDA for FY20 was steady, +NZ\$4m up on FY19, but -NZ\$10m below VCT's mid-point guidance provided at the 1H20 result. However, following the outbreak of COVID-19, VCT pulled guidance and it has estimated that COVID-19 cost -NZ\$10m, with impacts on lower electricity volumes and its HRV business. The Network contribution of NZ\$338m was -NZ\$29m (-8%) lower than the pcp due to lower volumes (COVID-19 impact), higher maintenance costs and the electricity price reset that took effect from 1 April 2020. In contrast, Metering EBITDA lifted +NZ\$16m (+11%) due to the continued roll-out of smart meters. The HRV business continues to disappoint, with VCT writing off a further NZ\$32m, in addition to the NZ\$47m write-off in FY19.

### No surprises with the dividend following policy reset at 1H20 result

The final dividend of 8.25cps, 30% imputed was the same as 1H20 and consistent with expectations. We are not forecasting a lift in dividends until FY23. In addition, VCT has NZ\$144m of prepaid tax that it has to work through before imputation can increase again.

### Outlook is for a flat FY21, with declining Networks contribution offset by Metering growth

The FY20 thematic of Metering growth offset by Network falls will continue in FY21. VCT's FY21 EBITDA guidance of NZ\$480m to NZ\$500m indicates growth will be hard to come by. Our revised FY21 EBITDA forecast of NZ\$496m (down -NZ\$1m), assumes Metering is the only segment to grow earnings. However, our NPAT forecast is up +22% to NZ\$149m, due mainly to lower net interest costs from falling interest rates, but also the accounting of the Kapuni asset sale results in interest income. That said, our dividend is unchanged at 16.5cps (30% imputed). High capex means debt levels will once again increase, we estimate by ~+NZ\$200m.

### Target price increase on cost of capital changes, but of the regulated stocks we prefer Chorus at these levels

Cost of capital changes have had a material impact on our DCF, up +55% to NZ\$4.13. The DCF benefits significantly in part because VCT's high gearing levels accentuate valuation increases. Our WACC assumption is now 4.8%, down from 6.7%. Whilst our target price is up +48% to NZ\$4.45, we have retained our NEUTRAL rating. We prefer other yield stocks, in particular the other regulated stock in NZ, Chorus, which is offering a better dividend yield and more growth at present than VCT.

**Vector Limited (VCT)**

Priced as at 27 Aug 2020 (NZ\$)

**4.26**
**12-month target price (NZ\$)\***
**4.45**

Expected share price return

4.5%

Net dividend yield

3.9%

Estimated 12-month return

8.3%

**Spot valuations (NZ\$)**

1. DCF

4.13

2. Dividend growth

4.55

3. n/a

n/a

**Key WACC assumptions**

Risk free rate

1.30%

Equity beta

0.84

WACC

4.8%

Terminal growth

1.5%

**DCF valuation summary (NZ\$m)**

Total firm value

6,997

(Net debt)/cash

(2,882)

Less: Capitalised operating leases

(38)

Value of equity

4,115

**Profit and Loss Account (NZ\$m)**

	2019A	2020A	2021E	2022E	2023E
Sales revenue	1,318.6	1,294.0	1,258.0	1,297.6	1,338.7
<b>Normalised EBITDA</b>	<b>565.1</b>	<b>576.4</b>	<b>589.4</b>	<b>613.7</b>	<b>640.5</b>
Depreciation and amortisation	(246.8)	(262.8)	(266.9)	(280.6)	(293.2)
<b>Normalised EBIT</b>	<b>318.3</b>	<b>313.6</b>	<b>322.6</b>	<b>333.1</b>	<b>347.2</b>
Net interest	(133.3)	(126.5)	(110.5)	(117.1)	(122.4)
Associate income	0.6	0.3	0.3	0.3	0.3
Tax	(52.5)	(55.2)	(61.6)	(62.7)	(65.3)
Minority interests	(1.1)	(1.9)	(1.9)	(1.9)	(1.9)
<b>Normalised NPAT</b>	<b>116.5</b>	<b>118.4</b>	<b>148.9</b>	<b>151.7</b>	<b>158.0</b>
Abnormals/other	(33.6)	(23.0)	0	0	0
<b>Reported NPAT</b>	<b>82.9</b>	<b>95.4</b>	<b>148.9</b>	<b>151.7</b>	<b>158.0</b>
Normalised EPS (cps)	11.7	11.9	14.9	15.2	15.9
DPS (cps)	16.5	16.5	16.5	16.5	16.8

**Growth Rates**

	2019A	2020A	2021A	2022A	2023A
Revenue (%)	0.6	-1.9	-2.8	3.2	3.2
EBITDA (%)	4.3	2.0	2.3	4.1	4.4
EBIT (%)	0.8	-1.5	2.9	3.3	4.2
Normalised NPAT (%)	-11.4	1.7	25.7	1.9	4.1
Normalised EPS (%)	-11.4	1.7	25.7	1.9	4.1
Ordinary DPS (%)	1.5	0.0	0.0	0.0	1.5

**Cash Flow (NZ\$m)**

	2019A	2020A	2021E	2022E	2023E
<b>EBITDA</b>	<b>565.1</b>	<b>576.4</b>	<b>589.4</b>	<b>613.7</b>	<b>640.5</b>
Working capital change	21.6	6.9	(37.2)	5.1	(1.8)
Interest & tax paid	(203.1)	(198.4)	(129.8)	(136.4)	(142.0)
Other	16.9	12.4	0	0	0
<b>Operating cash flow</b>	<b>400.5</b>	<b>397.3</b>	<b>422.4</b>	<b>482.4</b>	<b>496.7</b>
Capital expenditure	(418.4)	(476.4)	(484.3)	(496.0)	(473.7)
(Acquisitions)/divestments	(7.4)	0.2	0	0	0
Other	(1.6)	0	0	0	0
<b>Funding available/(required)</b>	<b>(26.9)</b>	<b>(78.9)</b>	<b>(61.9)</b>	<b>(13.6)</b>	<b>23.1</b>
Dividends paid	(164.1)	(167.0)	(164.4)	(164.4)	(166.9)
Equity raised/(returned)	0	0	0	0	0
<b>(Increase)/decrease in net debt</b>	<b>(191.0)</b>	<b>(245.9)</b>	<b>(226.2)</b>	<b>(178.0)</b>	<b>(143.8)</b>

**Balance Sheet (NZ\$m)**

	2019A	2020A	2021E	2022E	2023E
Working capital	54.4	139.2	144.2	105.8	71.7
Fixed assets	4,184.6	4,367.7	4,585.1	4,800.5	4,981.0
Intangibles	1,354.9	1,283.4	1,283.4	1,283.4	1,283.4
Right of use asset	38.1	35.8	35.8	35.8	35.8
Other assets	135.5	244.5	244.8	245.1	245.4
<b>Total funds employed</b>	<b>5,767.5</b>	<b>6,070.6</b>	<b>6,293.4</b>	<b>6,470.6</b>	<b>6,617.3</b>
Net debt/(cash)	2,733.4	3,107.3	3,333.5	3,511.5	3,655.3
Lease liability	39.9	37.8	37.8	37.8	37.8
Other liabilities	644.8	665.8	675.9	686.0	695.8
Shareholder's funds	2,332.4	2,242.8	2,227.3	2,214.6	2,205.7
Minority interests	17.0	16.9	18.8	20.7	22.6
<b>Total funding sources</b>	<b>5,767.5</b>	<b>6,070.6</b>	<b>6,293.4</b>	<b>6,470.6</b>	<b>6,617.3</b>

**Valuation Ratios**

	2019A	2020A	2021E	2022E	2023E
EV/EBITDA (x)	11.9	12.1	12.3	12.0	11.5
EV/EBIT (x)	21.2	22.3	22.4	22.1	21.2
PE (x)	36.4	35.8	28.5	28.0	26.9
Price/NTA (x)	4.3	4.4	4.5	4.6	4.6
Free cash flow yield (%)	-0.4	-1.9	-1.5	-0.3	0.5
Net dividend yield (%)	3.9	3.9	3.9	3.9	3.9
Gross dividend yield (%)	5.4	4.3	4.3	4.3	4.4

**Capital Structure**

	2019A	2020A	2021E	2022E	2023E
Interest cover EBIT (x)	2.4	2.5	2.9	2.8	2.8
Interest cover EBITDA (x)	4.2	4.6	5.3	5.2	5.2
Net debt/ND+E (%)	53.0	56.2	58.3	59.7	60.9
Net debt/EBITDA (x)	4.6	5.0	5.3	5.4	5.4

**Key Ratios**

	2019A	2020A	2021E	2022E	2023E
Return on assets (%)	5.3	4.9	4.9	4.9	5.0
Return on equity (%)	5.0	5.3	6.7	6.8	7.2
Return on funds employed (%)	4.6	4.3	4.3	4.3	4.4
EBITDA margin (%)	42.9	44.5	46.9	47.3	47.8
EBIT margin (%)	24.1	24.2	25.6	25.7	25.9
Capex to sales (%)	31.7	36.8	38.5	38.2	35.4
Capex to depreciation (%)	170	181	181	177	162
Imputation (%)	100	30	30	30	30
Pay-out ratio (%)	141	139	110	108	106

**Operating Performance**

	2019A	2020A	2021E	2022E	2023E
Electricity throughput (GWh)	8,410	8,315	8,426	8,543	8,666
Electricity connections (000)	571	580	589	597	606
Volume/customer (MWh)	14.8	14.4	14.4	14.4	14.4
Price (\$/MWh)	50.3	49.4	47.1	47.7	48.4
Gas distribution (PJ)	14.4	14.3	14.8	15.1	15.3
Gas connections (000)	112	114	116	117	119
Volume/customer (GJ)	130	127	129	129	129
Natural gas sales (PJ)	16.1	12.4	9.5	9.4	9.2
Liquid sales (000 tonnes)	79.2	43.3	45.1	47.4	49.3
Liquigas tolling (000 tonnes)	152	116	114	111	109
Smart meters (000)	1,558	1,714	1,885	2,036	2,178
Total meters (000)	1,875	2,027	2,207	2,411	2,581
Smart meter %	83.1	84.6	85.4	84.4	84.4

**Divisional EBITDA (NZ\$m)**

	2019A	2020A	2021E	2022E	2023E
Electricity	403	379	381	385	389
Gas Transport	43	44	47	49	53
Gas Trading	31	34	25	25	25
Metering	139	155	170	187	205
Corporate/Other	(50.9)	(35.60)	(33.3)	(32.2)	(31.2)
<b>Total EBITDA</b>	<b>565</b>	<b>576</b>	<b>589</b>	<b>614</b>	<b>640</b>
Customer contributions	79	86	94	93	92
<b>Adjusted EBITDA</b>	<b>486</b>	<b>490</b>	<b>496</b>	<b>521</b>	<b>548</b>

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

## Summary forecast changes

Figure 1. Summary forecast changes

	FY21 Old	FY21 New	Chg %	FY22 Old	FY22 New	Chg %	FY23 Old	FY23 New	Chg %
Revenue	1,332	1,258	-6%	1,363	1,298	-5%	1,397	1,339	-4%
EBITDA excl Capital Contributions	497	496	0%	518	521	1%	542	548	1%
EBITDA	585	589	1%	603	614	2%	627	640	2%
EBIT	311	323	4%	320	333	4%	336	347	3%
NPAT	124	151	22%	125	154	23%	131	160	22%
REPORTED PROFIT	122	149	22%	123	152	23%	129	158	22%
EPS	12.2	14.9	22%	12.4	15.2	23%	13.0	15.9	22%
Dividend (cps)	16.50	16.50	0%	16.50	16.50	0%	16.75	16.75	0%

Source: Forsyth Barr analysis

Changes to operating earnings are minor, and there is no change to our dividend forecast (or forecast imputation level of 30%).

Key changes to our forecasts include:

- Reduction in Network contribution (-NZ\$8m in FY21) due to higher operating costs (some of which is internal charges).
- Reduction in Gas Trading contribution (-NZ\$3m in FY21) due to sale of Kapuni and smaller natural gas book.
- No change to FY21 Metering EBITDA, but modest lift in FY22 and FY23 as the smart gas meter deal with Genesis Energy rolls out.
- Increase in "Corporate/other" EBITDA (+NZ\$10m), due to increased internal charges.
- Increase in capital contributions (+NZ\$6m in FY21) as VCT has increased the level of contributions required from developers.
- Significant decline in interest costs (-19% in FY21/FY22/FY23) due to interest rate falls greater than expected and the Kapuni asset sale that leads to interest income on the "contingent consideration".

## Result analysis

Figure 2. FY20 result analysis (NZ\$m)

NZ\$m	FY19	FY20	% Chg	FB	Diff \$m	Commentary
<b>Total Revenue</b>	<b>1,319</b>	<b>1,294</b>	<b>-2%</b>	<b>1,332</b>	<b>(38)</b>	Gas Trading revenue main driver of fall on lower natural gas sales
Total Costs	(754)	(718)	5%	(745)	28	
<b>EBITDA</b>						
Networks	367	338	-8%	353	(16)	Lift in maintenance costs, COVID-19 and lower price reset revenue combined to lower EBITDA
Gas Trading	31	34	8%	32	2	Strong margins and lift in Liquigas throughput offset lower natural gas sales and Kapuni sale
Metering	138	154	11%	155	(1)	In line with expectations – continues to be VCT's growth engine
Corporate & other	(51)	(36)	30%	(43)	7	Lower other opex and higher intersegment revenue offset weak HRV performance
<b>Adjusted EBITDA</b>	<b>486</b>	<b>490</b>	<b>1%</b>	<b>497</b>	<b>(7)</b>	Lower than forecast mainly due to COVID-19
Capital contributions	79	86	9%	90	(4)	Increase in contributions due to connections growth and higher replacement capex
<b>Group EBITDA</b>	<b>565</b>	<b>576</b>	<b>2%</b>	<b>587</b>	<b>(11)</b>	
Depn & Amort.	247	263	6%	264	(2)	Increase in depreciation driven by growth in asset base
<b>EBIT</b>	<b>318</b>	<b>314</b>	<b>-1%</b>	<b>323</b>	<b>(9)</b>	
FV mvmts	(3)	(3)		(1)	(2)	
Equity Earnings	1	0		0	0	
Asset impairment	(47)	(32)		-	-	Second year in a row HRV has been impaired
Net Interest	(133)	(127)	5%	(128)	2	Falling interest rates offset growth in debt levels
<b>Pretax</b>	<b>137</b>	<b>153</b>	<b>12%</b>	<b>194</b>	<b>(41)</b>	
Tax Expense/(Benefit)	53	55	5%	56	(1)	
<b>NPAT</b>	<b>84</b>	<b>97</b>	<b>16%</b>	<b>138</b>	<b>(40)</b>	
Minority Interests	(1)	(2)	-73%	(2)	0	
<b>REPORTED PROFIT</b>	<b>83</b>	<b>95</b>	<b>15%</b>	<b>136</b>	<b>(40)</b>	
Abnormal items	34	23	-31%	-	23	
<b>Normalised NPAT</b>	<b>116</b>	<b>118</b>	<b>2%</b>	<b>136</b>	<b>(17)</b>	
Normalised EPS	11.7	11.9	2%	13.6	(1.7)	
Final dividend per share	8.25	8.25	0%	8.25	0.00	Dividend in line with expectations, 30% imputed
FY dividend per share	16.50	16.50	0%	16.50	0.00	

Source: VCT, Forsyth Barr analysis

## 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 and starts rolling out gas smart meters for Genesis Energy.
- **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 both FY19 and FY20.

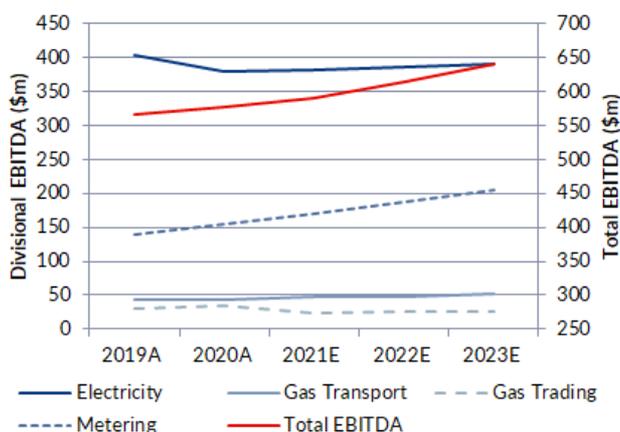
### Financial structure

- **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

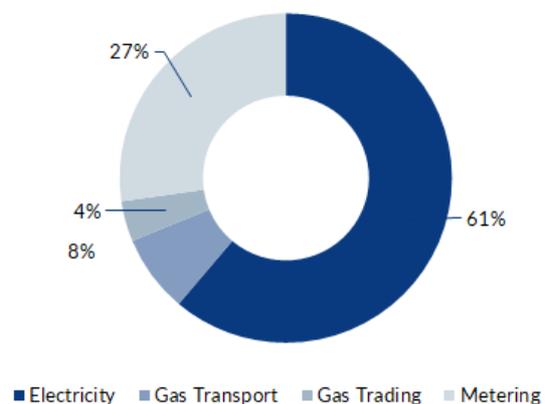
- **Regulation:** Negative regulatory settings are a key earnings risk. We view the current level of risk as medium.
- **Disruptive technology:** Solar roll-out may reduce lines company demand, although any impact is at least 10 years away. VCT is investing in solar and batteries to minimise the threat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

Figure 3. Divisional EBITDA

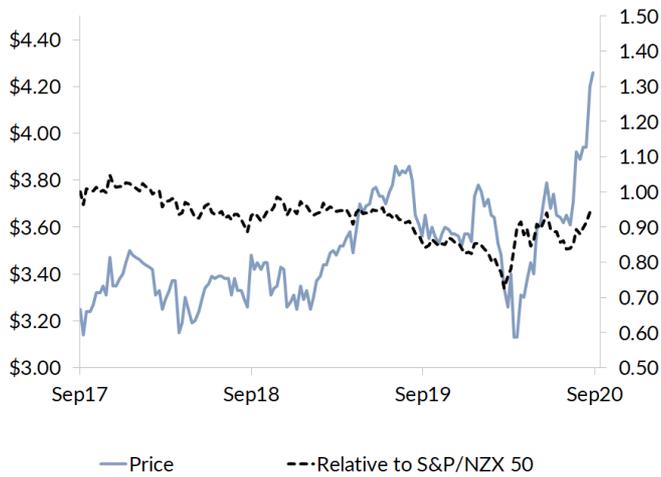


Source: VCT, Forsyth Barr analysis

Figure 4. FY21E EBITDA breakdown



Source: VCT, Forsyth Barr analysis

**Figure 5. Price performance**


Source: Forsyth Barr analysis

**Figure 6. Substantial shareholders**

Shareholder	Latest Holding
Entrust	75.1%

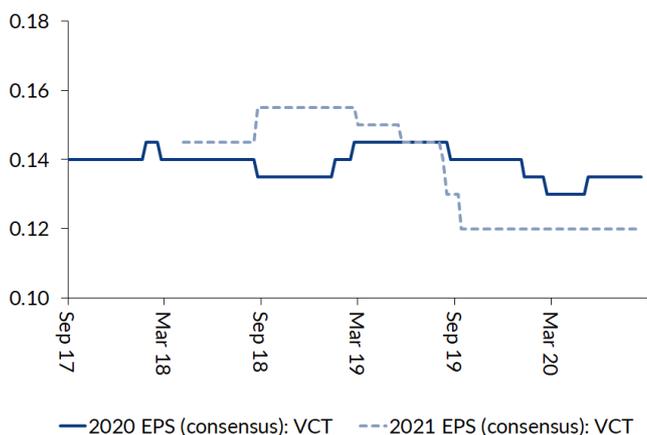
Source: NZX, Forsyth Barr analysis, NOTE: based on SPH notices only

**Figure 7. International valuation comparisons**

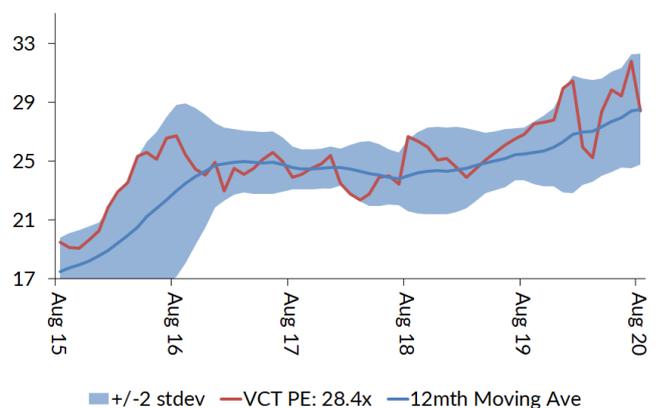
Company	Code	Price	Mkt Cap (m)	PE		EV/EBITDA		EV/EBIT		Cash Yld
				2021E	2022E	2021E	2022E	2021E	2022E	
Vector	VCT NZ	NZ\$4.26	NZ\$4,242	28.5x	28.0x	12.1x	11.6x	22.1x	21.4x	3.9%
APA GROUP	APA AT	A\$10.42	A\$12,294	38.6x	33.9x	13.3x	12.7x	22.1x	20.7x	5.0%
AUSNET SERVICES	AST AT	A\$1.84	A\$6,887	25.7x	27.4x	13.6x	13.7x	22.9x	23.2x	5.1%
CHORUS *	CNU NZ	NZ\$8.61	NZ\$3,825	>50x	>50x	10.0x	9.7x	28.0x	27.4x	4.1%
SPARK INFRASTRUCTURE GROUP	SKI AT	A\$2.19	A\$3,771	44.7x	>50x	7.4x	7.6x	17.3x	20.2x	5.7%
<b>Compco Average:</b>				<b>36.3x</b>	<b>30.7x</b>	<b>11.1x</b>	<b>10.9x</b>	<b>22.6x</b>	<b>22.9x</b>	<b>5.0%</b>
<b>VCT Relative:</b>				<b>-22%</b>	<b>-9%</b>	<b>9%</b>	<b>6%</b>	<b>-2%</b>	<b>-7%</b>	<b>-22%</b>

EV = Current Market Cap + Actual Net Debt

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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	<b>47.2%</b>	<b>39.6%</b>	<b>13.2%</b>

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