Z Energy

OUTPERFORM

Regulatory Risk Not Terminal

The Commerce Commission (ComCom) has released its Draft Report into the retail fuel sector and whilst it contains few surprises, in our view it raises more questions than answers. The fundamental question for investors is whether the ComCom's proposed solutions will have a material impact on earnings? We are not convinced that they will.

Suggested solutions expected, but will they achieve the desired outcome?

The ComCom's initial view is that the fuel market is not as competitive as it could be. Its proposed solutions are focussed on improving competition in the wholesale supply of fuel and would seek to make it easier for fuel resellers (such as Waitomo) to switch suppliers and to increase access to the shared terminal infrastructure. These proposed recommendations were expected, so the ComCom has not surprised on that front. The key question is whether it will make a material difference to margins and we are not convinced it will. Opening up the wholesale market risks unintended consequences and Z Energy (ZEL) has, in the past, said it does not fear transparent wholesale pricing. It is worth noting that under questioning the ComCom ruled out direct regulatory price control of the retail market.

Profitability analysis raises more questions than answers

A key plank the ComCom has relied on is its assertion that all fuel retailers are over-earning. However, the analysis raises several questions, such as, why have returns increased materially in the past two to three years when margins have not? (It appears the ComCom may be using historic cost accounts as opposed to replacement cost). And why is the replacement cost of ZEL's terminal facilities only 2x Gull's, yet it has ~6x the quantity of terminals? Whilst ZEL's financial performance has been strong, we do not believe ZEL's return on average capital employed (ROACE) is ~22% as the ComCom calculates. ZEL calculates its ROACE is low-teens.

Economic theory vs. commercial reality

An issue we have is the ComCom noting that returns have been too high for a prolonged period of time and that retail competition is not working. In our view competition has only started entering the market in the past three years in a meaningful way, with more to come — in particular, the opening of a third-party terminal in Timaru and expansion of Gull and Waitomo into the South Island. Given the lead times associated with infrastructure investment, we are not surprised it has taken time for meaningful competition to emerge.

Any wholesale market solution will take time to implement

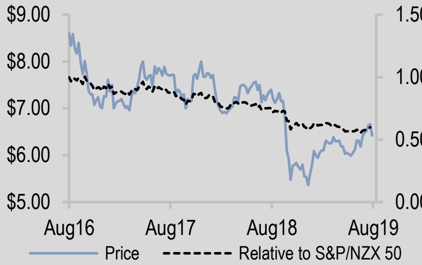
If the wholesale market is to be opened up, it will be several years before that happens. After the ComCom's final report is released in December 2019 the Government will have to implement any recommended changes, which we expect will take a significant amount of time given the complexities and the need to minimise unintended consequences. Whilst our view is that the proposed recommendations are unlikely to have a material impact on ZEL, we probably will not know for certain for at least five years. In other words, regulatory uncertainty is ZEL's new norm.

Investment View

Our rating is OUTPERFORM. ZEL's FY20 dividend guidance demonstrates confidence in the future earnings outlook for the business. Whilst increasing competition and regulatory threats are a challenge, we believe the downside risks are adequately factored into the share price.

NZX Code	ZEL
Share price	NZ$6.42
Target price	NZ$6.50
Risk rating	Medium
Issued shares	400.0m
Market cap	NZ$2,568m
Average daily turnover	936.3k (NZ$5,752k)

Share Price Performance



Financials: March	19A	20E	21E	22E
NPAT* (NZ$m)	195.8	204.3	221.2	222.5
EPS* (NZc)	49.0	51.1	55.3	55.6
EPS growth* (%)	-7.4	4.3	8.2	0.6
DPS (NZc)	43.0	50.0	52.5	55.0
Imputation (%)	100	100	100	100

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	7.6	7.2	7.0	7.1
EV/EBIT	10.6	10.2	9.4	9.4
PE	13.1	12.6	11.6	11.5
Price / NTA	10.6	9.0	7.7	n/a
Cash dividend yield (%)	6.7	7.8	8.2	8.6
Gross dividend yield (%)	9.3	10.8	11.4	11.9

*Historic and forecast numbers based on underlying profits

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Z Energy (ZEL) Priced as at 20 Aug 2019: NZ$6.42 March year end

Forsyth Barr valuation			
Valuation methodology			Blend of spot valuations
12-month target price (NZ$)*	**6.50**	**Spot valuations (NZ$)**	
Expected share price return	1.2%	1. DCF	6.31
Net dividend yield	8.0%	2. Dividend Yield	6.61
Estimated 12-month return	9.2%	3. Market Multiple	6.46
Key WACC assumptions		**DCF valuation summary (NZ$m)**	
Risk free rate	2.75%	Total firm value	3,666
Equity beta	0.84	(Net debt)/cash	1,025
WACC	7.4%	Value of equity	2,558
Terminal growth	-2.0%	Shares (m)	400

Profit and Loss Account (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Sales revenue	4,570	5,450	5,107	5,204	5,213
Normalised EBITDA	**448**	**435**	**449**	**456**	**450**
Depreciation and amortisation	(102)	(122)	(129)	(115)	(110)
Normalised EBIT	**347**	**312**	**320**	**341**	**340**
Net interest	(52)	(51)	(48)	(45)	(41)
Associate income	1	(1)	-	-	-
Tax	(82)	(61)	(76)	(83)	(84)
Minority interests	-	(2)	(9)	(8)	(7)
Normalised NPAT	**211**	**196**	**204**	**221**	**222**
Abnormals/other	(6)	(16)	-	-	-
Reported NPAT	**205**	**180**	**204**	**221**	**222**
Normalised EPS (cps)	52.9	49.0	51.1	55.3	55.6
DPS (cps)	32.3	43.0	50.0	52.5	55.0

Growth Rates	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Revenue (%)	18.3	19.3	-6.3	1.9	0.2
EBITDA (%)	6.9	-2.9	3.2	1.6	-1.3
EBIT (%)	3.3	-10.1	2.4	6.7	-0.2
Normalised NPAT (%)	8.2	-7.4	4.3	8.2	0.6
Normalised EPS (%)	8.2	-7.4	4.3	8.2	0.6
DPS (%)	10.2	33.1	16.3	5.0	4.8

Cash Flow (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EBITDA	**448**	**435**	**449**	**456**	**450**
Working capital change	61	(159)	52	(13)	(0)
Interest & tax paid	(103)	(161)	(129)	(131)	(129)
Other	(15)	223	-	-	-
Operating cash flow	**391**	**338**	**371**	**312**	**320**
Capital expenditure	(87)	(55)	(91)	(46)	(47)
(Acquisitions)/divestments	18	(28)	-	-	-
Other	12	4	4	6	6
Funding available/(required)	**334**	**259**	**284**	**271**	**279**
Dividends paid	(134)	(152)	(182)	(206)	(216)
Equity raised/(returned)	(2)	(1)	-	-	-
Increase/(decrease) in net debt	**(198)**	**(106)**	**(102)**	**(65)**	**(63)**

Balance Sheet (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Working capital	196	358	333	347	347
Fixed assets	870	830	821	793	766
Intangibles	750	668	639	599	562
Other assets	134	161	134	134	134
Total funds employed	**1,950**	**2,017**	**1,927**	**1,872**	**1,809**
Net debt/(cash)	824	827	729	669	612
Other non current liabilities	269	270	265	262	257
Shareholder's funds	857	920	933	940	940
Minority interests	-	-	-	-	-
Total funding sources	**1,950**	**2,017**	**1,927**	**1,872**	**1,809**

Valuation Ratios	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EV/EBITDA (x)	7.6	7.6	7.2	7.0	7.1
EV/EBIT (x)	9.8	10.6	10.2	9.4	9.4
PE (x)	12.1	13.1	12.6	11.6	11.5
Price/NTA (x)	20.5	10.6	9.0	7.7	6.9
Free cash flow yield (%)	11.8	11.0	10.9	10.3	10.6
Net dividend yield (%)	5.0	6.7	7.8	8.2	8.6
Gross dividend yield (%)	7.0	9.3	10.8	11.4	11.9
Imputation (%)	100	100	100	100	100
Pay-out ratio (%)	61	88	98	95	99

Capital Structure	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Interest cover EBIT (x)	6.7	6.1	6.6	7.6	8.3
Interest cover EBITDA (x)	8.6	8.5	9.3	10.2	11.0
Net debt/ND+E (%)	57.2	55.4	51.4	48.7	46.3
Net debt/EBITDA (x)	1.8	1.9	1.62	1.47	1.36

Key Ratios	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Return on assets (%)	12.4	11.0	11.7	12.4	12.4
Return on equity (%)	24.2	21.5	22.1	23.7	23.8
Return on funds employed (%)	17.4	15.8	16.2	17.9	18.5
EBITDA margin (%)	9.8	8.0	8.8	8.8	8.6
EBIT margin (%)	7.6	5.7	6.3	6.5	6.5
Capex to sales (%)	1.9	1.0	1.8	0.9	0.9
Capex to depreciation (%)	140	85	138	69	71

Operating Performance	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Product volumes (m litres)					
Petrol	1,204	1,165	1,173	1,157	1,147
Diesel - retail	461	454	461	450	441
Diesel - commercial	807	812	823	837	853
Diesel - biofuels	-	1	7	15	23
Other fuels	1,153	1,193	1,173	1,171	1,186
Supply - domestic	520	544	553	566	574
Sub-total	**4,145**	**4,168**	**4,190**	**4,197**	**4,224**
Supply - industry & export	178	280	95	127	125
Total Fuels	**4,323**	**4,448**	**4,285**	**4,324**	**4,350**
Retail service stations	343	343	340	340	337
Petrol/service station (m litres)	3.74	3.63	3.67	3.64	3.61
Diesel/service station (m litres)	1.34	1.32	1.35	1.32	1.30
Gross profit (NZDm)					
Fuels	685	700	715	707	700
Refining	77	54	68	69	67
Non-fuels	76	81	85	89	91
Flick Electric	-	1	7	9	11
Gross profit	**838**	**836**	**875**	**874**	**870**
Fuels gross margin (cpl)	16.5	16.8	17.1	16.9	16.6
Fuels margin incl refining (cpl)	17.6	17.0	18.3	18.0	17.6
Fuels margin excl supply (cpl)	18.3	18.0	18.7	18.5	18.1
Non-fuels revenue/station (NZD 000)	373	398	422	442	454
Refining volume (m barrels)	21.3	19.7	21.5	21.5	21.4
Sales sourced from refinery (%)	82	75	82	81	81
ZEL refining margin (USD/barrel)	8.6	6.2	7.3	7.4	7.2
Flick customer numbers (000)	-	20.5	25.9	32.3	38.1

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

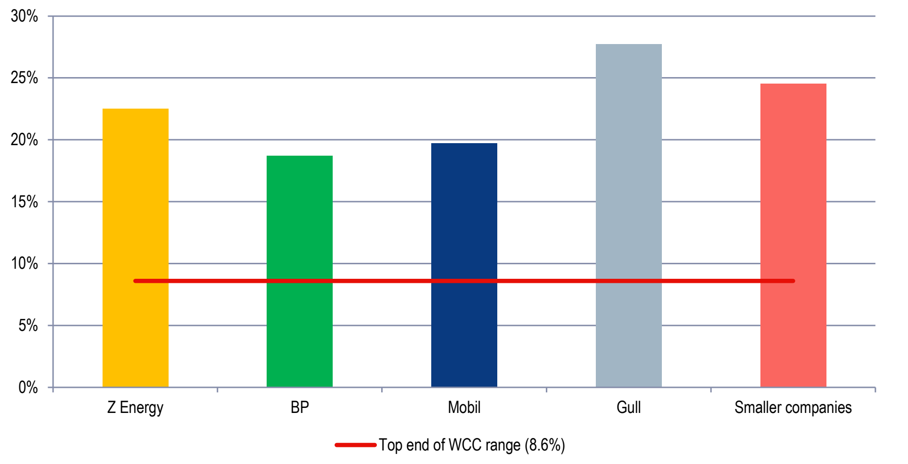
Summary of ComCom findings and recommendations

The ComCom's core finding is that, "the fuel market is not as competitive as it could be". The basis for this conclusion include:

- "Many fuel companies are highly profitable
- Regional differences in retail fuel prices reflect variations in competition levels
- Discounting does not provide a substitute for competition on board prices
- Premium petrol margins have grown faster than regular petrol"

The perceived high level of profitability within the industry is central to the ComCom's conclusions, as highlighted by the following figure.

Figure 1. ComCom's estimated average ROACE 2016–2018 vs ComCom WACC estimate



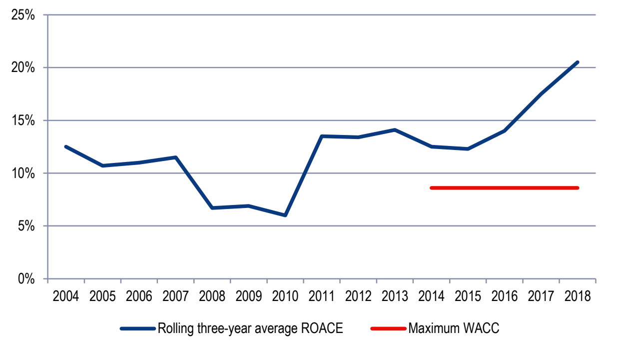
Source: Commerce Commission

We have some issues with the profitability and margin analysis

Following a preliminary review of the ComCom's 423 page report we have several issues with its profitability and margin analysis:

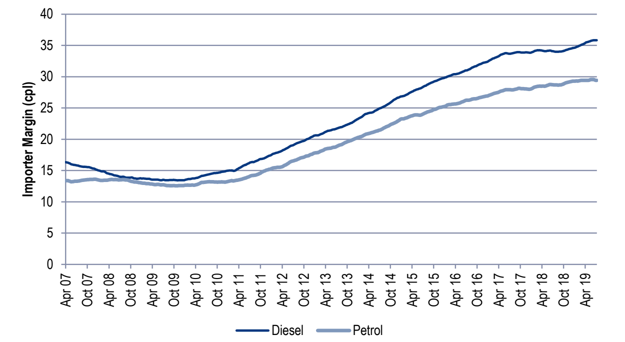
1) The ComCom's analysis shows a material increase in the rolling three-year ROACE from 2016 onwards (Figure 2). This actually coincides with the rolling three-MBIE importer margins flattening off (Figure 3). We would have expected a better correlation.

Figure 2. NZ firms' three-year rolling average ROACE



Source: Commerce Commission

Figure 3. Rolling three-year MBIE importer margins

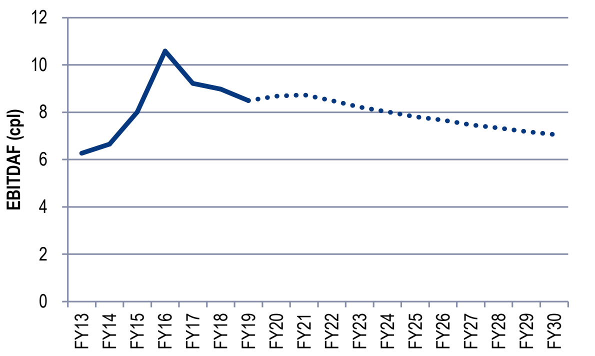


Source: MBIE, Forsyth Barr analysis

In addition, ZEL's EBITDAF has been roughly flat for the last three years, which is more consistent with the MBIE margin trend than the ComCom's ROACE analysis.

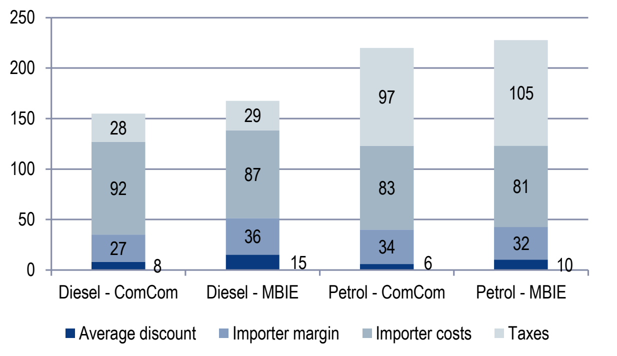
2) The ComCom notes industry commentary from 2012/2013 suggesting there is a threat of new competition due to rising retail fuel margins. In our view, competition has only started to bite in the last two to three years. Given the timeframes involved to invest in infrastructure assets, and the fact competition is likely to occur in certain regions as opposed to nationwide simultaneously, the fact margins only started to plateau in the last three years should have been expected. We expect (and forecast) ZEL's profit margins to decline over the next few years (in addition to declining retail volumes), consistent with increased retail competition (Figure 4). In our view the ComCom has come to a premature conclusion around industry profitability.

Figure 4. EBITDAF/litre (excl non-fuels)



Source: ZEL, Forsyth Barr analysis

Figure 5. MBIE vs. ComCom retail price components (Jul-Dec 2018)



Source: ComCom, MBIE, Forsyth Barr analysis

3) The ComCom estimates that the replacement cost of Gull's terminal facilities is between \$80m–\$120m. It estimates ZEL's terminal facilities have a depreciated replacement cost of \$172m. However, ZEL owns terminal facilities in seven ports, plus has joint venture ownership arrangements in a further three. ZEL's value looks low compared to Gull's.

4) The ComCom notes that the hurdle rates and forecast internal rates of return (IRR) used in investment case analysis are materially higher than its estimated maximum acceptable WACC of 8.6%. It also notes that the investment cases often do not include terminal values. In our view, that shows good investment discipline and arguably shouldn't be used as evidence of excess returns. Hurdle rates should be well above WACC and in an industry that is often seen as a sunset industry, it is prudent not to include a terminal value.

5) Highlighting the difficulty with margin analysis, the ComCom's calculation of the retail price breakdown is materially different to the MBIE reported data in two ways (Figure 5). First, the ComCom estimates that the discounts are significantly lower and there is a discrepancy with estimated petrol taxes and diesel importer margins. Second, the ComCom estimates that diesel margins are lower than petrol margins, whereas according to MBIE, petrol margins are always below diesel margins (Figure 3).

6) It is interesting to note that, according to the ComCom, the smaller retailers (Gull, GAS, NPD and Waitomo) have greater ROACE than any of the three large integrated players and certainly do not appear to be struggling (Figure 1). It raises the question in our mind whether the wholesale market is really the problem (and therefore whether making changes to the wholesale market will make much difference)?

We also have some question marks around the appropriateness of the ComCom's WACC estimate. For example, is it reasonable to assume earnings in a competitive market will fall because interest rates fall? The ComCom's choice of risk free rate implicitly assumes it is reasonable.

In summary, whilst we do not disagree that ZEL (and the industry) have done and are doing well at present, we do not believe it is doing as well as the ComCom suggests and there are a number of questions surrounding its analysis, and ergo its conclusions.

Possible scenarios vs. likely outcomes

Whilst it is our view that there are no unexpected proposed recommendations within the ComCom report and that the proposed recommendations are unlikely to have a material impact on margins, it is worth considering possible downside scenarios.

Possible downside risk

One of the issues the ComCom raises is the margin for 95 and 98 octane petrol over regular 91 octane petrol has increased from ~7.5cpl to ~14.0cpl currently. It is difficult to rationalise why there has been a significant increase in the premium margin. Based on a small sample, it appears to us that ZEL's margin differential is less than the market average of ~14cpl, meaning if the premium was to reduce to historic levels, the impact should be less for ZEL. Nevertheless, we estimate that ZEL's margin impact would be -\$5m to -\$10m.

Worst case difficult to assess and in our view implausible

Whilst we believe it is highly unlikely and question the ComCom's analysis, if ZEL's ROACE were to fall from the claimed ~22% to ~8.5%, we estimate that the theoretical earnings (NPAT) impact would be -\$140m. However, it appears that the ComCom has included revaluation gains as part of ZEL's ROACE calculation. Revaluation gains are non-cash returns, hence, arguably under a do nothing scenario, ZEL's ROACE would fall simply because revaluation gains cannot be assumed to continue (particularly in an industry with significant stranding risk). The ComCom has not provided enough detail to ascertain how significant revaluation gains are within its ROACE analysis.

Any changes will take time to have an effect

The ComCom acknowledges that any regulatory changes will take time to have an effect. After the final report is released on Thursday 5 December, the Government will have to analyse the report and then move towards implementing recommendations. Whilst the Government is undertaking work in the background, any significant changes to the wholesale fuel market, such as opening up the industry arrangements or implementing terminal gate pricing will take time. In our view, it is unlikely that any material changes could be expected to be felt within five years. Regulatory uncertainty is the new normal for ZEL.

Timetable from here

Figure 6. ComCom fuel study timetable

Next step	Date
Submission on draft report due	Friday 13 September
Consultation conference	Tuesday 24 September – Friday 27 September
Post-conference comments due	Friday 11 October
ComCom publishes the final report	Thursday 5 December

Source: ComCom

Investment summary

Our rating is OUTPERFORM. ZEL's FY20 dividend guidance demonstrates confidence in the future earnings outlook for the business. Whilst increasing competition and regulatory threats are a challenge, we believe the downside risks are adequately factored into the share price.

Business quality

- **Industry structure:** The industry is an oligopoly dominated by ZEL, BP, and Mobil (Exxon). ZEL's NZ-centric business model provides it with a market leading position. ZEL sells ~45% of NZ fuel volumes.
- **Refining performance:** ZEL refines ~75% of its product at NZR. NZR is generally a positive and provides a competitive advantage over imported product when refining margins are high.

Earnings and cash flow outlook

- **Fuel margins:** Fuel margins are the key value driver and have been flat over the past two years. We expect retail margins to gradually decrease due to increased retail competition.
- **Sales volumes:** Fuel demand is generally inelastic, so whilst it is an important value driver its variability is less than margins. However, volumes are important for maintaining supply chain economics.
- **Retail initiatives:** ZEL has several retail initiatives that should help address market share declines. It has a new loyalty programme and a new product enabling consumers to lock in prices and discounts.

Financial structure

- **Dividend growth:** ZEL has significant free cash flow. We anticipate the FY20 dividend will be 50cps, which still allows for significant debt repayment. ZEL is targeting net debt/EBITDAF of between 1.6x and 2.0x by the end of FY21.
- **Flick Electric:** ZEL has acquired a 70% stake in electricity retailer Flick Electric. We do not expect it to impact on earnings in the near-term.

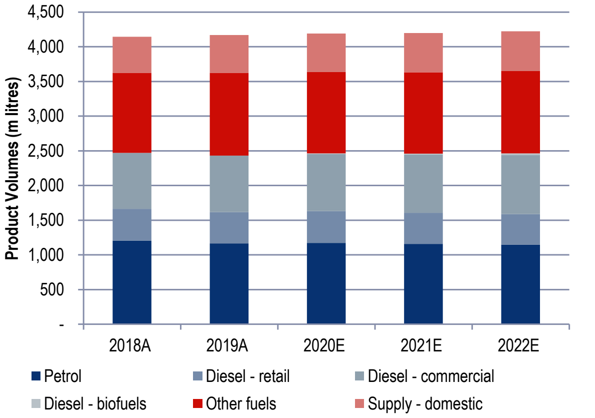
Key risks

- **Long-term threat to industry volumes:** Increased vehicle efficiency and the threat from electric vehicles will pressure industry volumes. However, the near-term risks are low with industry volumes growing.
- **Fuel Price Inquiry:** High fuel margins have created political noise about fuel prices, resulting in legislation enabling the Commerce Commission to undertake market studies. The study is due by the end of 2019.

Company description

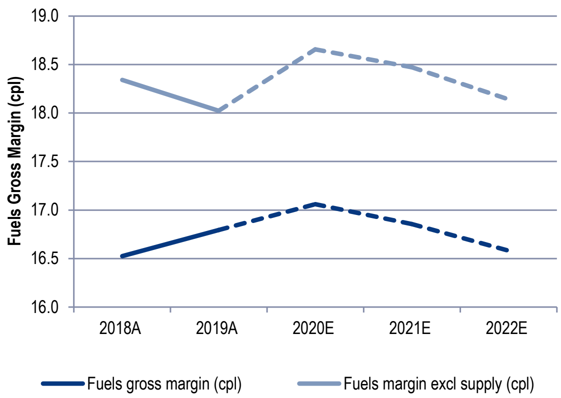
Z Energy is a downstream oil company. Its products include petrol, diesel, marine fuel oil and aviation fuel. Z retails petrol and diesel through a network of ~200 Z branded service stations and ~140 Caltex branded service stations. It sells fuel to the commercial market, which includes a network of 161 truck stops. ZEL also owns terminal storage facilities in 12 centres, share of local distribution ships and distribution infrastructure, 15% of Refining NZ (NZR), 25% of Loyalty NZ (Fly Buys) and 70% of electricity retailer Flick Electric. It has also recently opened a bio-diesel plant in Wiri, South Auckland.

Figure 7. Product volumes



Source: ZEL, Forsyth Barr analysis

Figure 8. Fuels gross margin



Source: ZEL, Forsyth Barr analysis

Figure 9. Substantial Shareholders

Shareholder	Latest Holding
Lazard	6.7%
Commonwealth Bank of Australia	6.1%
Investor Mutual	5.1%
ACC	5.0%

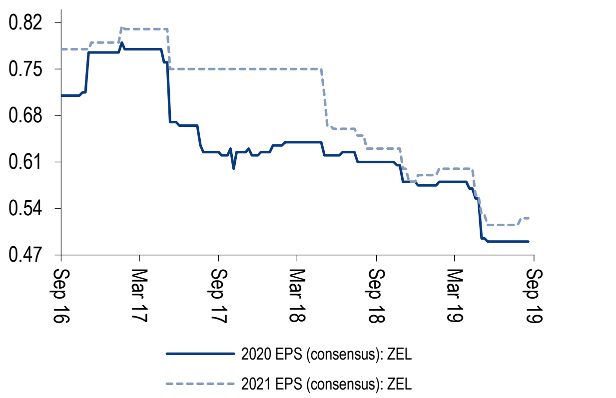
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 10. International Compcos

Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash D/Yld
(metrics re-weighted to reflect ZEL's balance date - March)			(m)	2020E	2021E	2020E	2021E	2020E	2021E	2021E
Z Energy	**ZEL NZ**	**NZ$6.42**	**NZ$2,568**	**12.6x**	**11.6x**	**7.6x**	**7.4x**	**10.6x**	**10.0x**	**8.2%**
Suburban Propane Partners LP	SPH US	US$22.93	US$1,415	17.2x	15.7x	9.3x	9.0x	16.6x	16.8x	10.8%
World Fuel Services Corp	INT US	US$38.22	US$2,499	15.6x	13.2x	7.7x	7.3x	9.9x	9.5x	n/a
Contact Energy *	CEN NZ	NZ$8.44	NZ$6,050	22.5x	22.8x	14.1x	14.3x	23.9x	24.2x	4.7%
Mercury *	MCY NZ	NZ$4.94	NZ$6,730	27.1x	25.9x	16.3x	15.9x	26.6x	25.2x	3.2%
Trustpower *	TPW NZ	NZ$7.62	NZ$2,385	22.8x	22.3x	14.1x	13.7x	17.8x	17.2x	4.6%
Meridian Energy *	MEL NZ	NZ$4.67	NZ$11,969	26.8x	28.0x	17.2x	17.7x	26.5x	27.4x	4.5%
Genesis Energy *	GNE NZ	NZ$3.26	NZ$3,332	19.2x	16.8x	12.4x	11.4x	26.9x	23.4x	5.5%
Caltex Australia	CTX AT	A$25.83	A$6,450	16.7x	12.8x	7.3x	6.3x	11.3x	9.2x	4.5%
Viva Energy Group	VEA AT	A$2.22	A$4,317	n/a	13.8x	7.6x	6.3x	10.7x	8.4x	4.5%
			Compco Average:	**21.0x**	**19.0x**	**11.8x**	**11.3x**	**18.9x**	**17.9x**	**5.3%**
EV = Current Market Cap + Actual Net Debt			**ZEL Relative:**	**-40%**	**-39%**	**-36%**	**-34%**	**-44%**	**-44%**	**+54%**

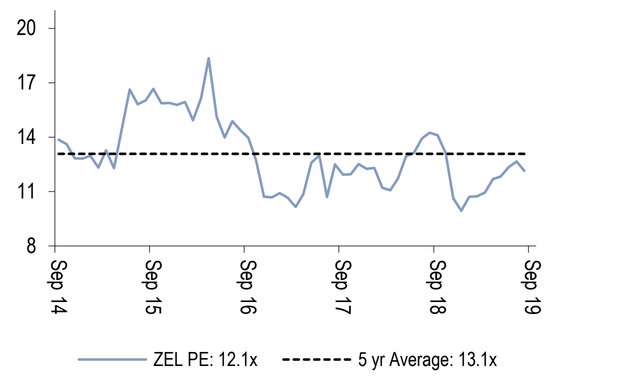
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (ZEL) companies fiscal year end

Figure 11. Consensus EPS Momentum



Source: Forsyth Barr analysis, Bloomberg

Figure 12. 12 Month Forward PE



Source: Forsyth Barr analysis