FORSYTH BARR

Z Energy

NEUTRAL

Spooky Halloween Result — 1H20 Result Preview

Having spooked the market with its earnings downgrade in September, we are expecting Z Energy (ZEL) to report a poor 1H20 result, although it shouldn't spook investors further. Our 1H20 EBITDAF forecast is $163m, -7% lower than the weak 1H19 result. However, following the guidance downgrade, we expect most focus to be whether ZEL has seen any improvement in the market conditions that led to the downgrade.

What we're expecting:

- **Reporting date:** Thursday 31 October
- **1H20 EBITDAF:** $163m, -$12m (-7%) lower than the pcp
- **1H20 Normalised NPAT and EPS:** $58m & 14.4cps, -$19m & -4.1cps (-22%) below the pcp respectively
- **1H20 dividend:** 14.0cps, +1.5cps up on the pcp

Poor result to be expected, with IFRS 16 to mask some of the downside

Our 1H20 EBITDAF forecast is $163m. This excludes an expected +$12m benefit from IFRS 16 (due to lower operating costs). Including IFRS 16 changes, we expect 1H20 EBITDAF to be similar to 1H19. Our NPAT and EPS forecasts are down -22%, as higher depreciation (again, excluding IFRS 16 depreciation) and tax costs (the effective 1H19 tax rate was low at 19%) impact the bottom line.

Focus on trading conditions over the past six weeks

Following its earnings downgrade in mid-September, ZEL has been in purgatory with the market and the 1H20 result will be its first small step back to redemption. The key question that the market needs comfort on is the sustainable level of earnings in the business. To that end, commentary on recent trading conditions will be crucial. Our understanding is that whilst conditions are better than August, competitive pressures remain and margins are still below where ZEL would expect them to be.

Dividend signalling will be interesting

ZEL's 1H19 interim dividend was 12.5cps, materially below market expectations. If ZEL is confident of paying an FY20 dividend of 48cps, its 1H/2H split would suggest an interim dividend of 16.8cps. However, there is no earnings growth to justify such an increase. Our 1H20 dividend forecast of 14.0cps, +1.5cps higher than the pcp, reflects the 1H19 dividend being impacted by ZEL's cautious approach to cash tax payments, but also the fact that 1H20 earnings probably do not justify a 16.8cps dividend. Given all the recent attention on ZEL's dividend policy, it will be interesting to see where it lands.

Investment View

Our rating is NEUTRAL. Whilst ZEL entices investors with a very attractive dividend yield, challenges in the retail market and the overshadowing of the ComCom Fuel Study means further earnings and therefore dividend downside cannot be ruled out. We believe ZEL once again has to demonstrate to the market that it is able to deliver sustainable earnings, preferably with less volatility than the past two years.

NZX Code	ZEL
Share price	NZ$5.53
Target price	NZ$5.40
Risk rating	Medium
Issued shares	400.0m
Market cap	NZ$2,212m
Average daily turnover	959.9k (NZ$5,736k)

Share Price Performance

Financials: March	19A	20E	21E	22E
NPAT* (NZ$m)	195.8	149.9	190.0	190.3
EPS* (NZc)	49.0	37.5	47.5	47.6
EPS growth* (%)	-7.4	-23.5	26.8	0.2
DPS (NZc)	43.0	48.0	49.0	50.0
Imputation (%)	100	100	100	100

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	6.8	7.8	6.9	7.0
EV/EBIT	9.4	11.8	9.5	9.6
PE	11.3	14.8	11.6	11.6
Price / NTA	9.1	9.4	8.3	n/a
Cash dividend yield (%)	7.8	8.7	8.9	9.0
Gross dividend yield (%)	10.8	12.1	12.3	12.6

*Historic and forecast numbers based on underlying profits

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Z Energy (ZEL) Priced as at 18 Oct 2019: NZ$5.53 March year end

Forsyth Barr valuation					
Valuation methodology				Blend of spot valuations	
12-month target price (NZ$)*	**5.40**	**Spot valuations (NZ$)**			
Expected share price return	-2.4%	1. DCF			5.44
Net dividend yield	8.8%	2. Dividend Yield			5.56
Estimated 12-month return	6.4%	3. Market Multiple			5.35
Key WACC assumptions		**DCF valuation summary (NZ$m)**			
Risk free rate	2.00%	Total firm value			3,448
Equity beta	0.84	(Net debt)/cash			1,025
WACC	7.1%	Value of equity			2,340
Terminal growth	-2.0%	Shares (m)			400

Profit and Loss Account (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Sales revenue	4,570	5,450	4,958	4,998	4,919
Normalised EBITDA	**448**	**435**	**374**	**412**	**406**
Depreciation and amortisation	(102)	(122)	(129)	(113)	(108)
Normalised EBIT	**347**	**312**	**245**	**299**	**298**
Net interest	(52)	(51)	(49)	(47)	(43)
Associate income	1	(1)	-	-	-
Tax	(82)	(61)	(55)	(71)	(71)
Minority interests	-	(2)	(9)	(8)	(7)
Normalised NPAT	**211**	**196**	**150**	**190**	**190**
Abnormals/other	(6)	(16)	-	-	-
Reported NPAT	**205**	**180**	**150**	**190**	**190**
Normalised EPS (cps)	52.9	49.0	37.5	47.5	47.6
DPS (cps)	32.3	43.0	48.0	49.0	50.0

Growth Rates	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Revenue (%)	18.3	19.3	-9.0	0.8	-1.6
EBITDA (%)	6.9	-2.9	-14.1	10.4	-1.5
EBIT (%)	3.3	-10.1	-21.5	22.2	-0.5
Normalised NPAT (%)	8.2	-7.4	-23.5	26.8	0.2
Normalised EPS (%)	8.2	-7.4	-23.5	26.8	0.2
DPS (%)	10.2	33.1	11.6	2.1	2.0

Cash Flow (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EBITDA	**448**	**435**	**374**	**412**	**406**
Working capital change	61	(159)	62	(4)	5
Interest & tax paid	(103)	(161)	(109)	(120)	(119)
Other	(15)	223	-	-	-
Operating cash flow	**391**	**338**	**327**	**288**	**292**
Capital expenditure	(87)	(55)	(91)	(46)	(47)
(Acquisitions)/divestments	18	(28)	25	-	-
Other	12	4	4	6	6
Funding available/(required)	**334**	**259**	**265**	**248**	**251**
Dividends paid	(134)	(152)	(178)	(194)	(198)
Equity raised/(returned)	(2)	(1)	-	-	-
Increase/(decrease) in net debt	**(198)**	**(106)**	**(87)**	**(54)**	**(53)**

Balance Sheet (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Working capital	196	358	323	327	322
Fixed assets	870	830	797	770	745
Intangibles	750	668	639	599	562
Other assets	134	161	134	134	134
Total funds employed	**1,950**	**2,017**	**1,892**	**1,829**	**1,763**
Net debt/(cash)	824	827	744	696	648
Other non current liabilities	269	270	265	263	259
Shareholder's funds	857	920	883	871	856
Minority interests	-	-	-	-	-
Total funding sources	**1,950**	**2,017**	**1,892**	**1,829**	**1,763**

Valuation Ratios	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EV/EBITDA (x)	6.8	6.8	7.8	6.9	7.0
EV/EBIT (x)	8.7	9.4	11.8	9.5	9.6
PE (x)	10.5	11.3	14.8	11.6	11.6
Price/NTA (x)	17.7	9.1	9.4	8.3	7.7
Free cash flow yield (%)	13.7	12.8	10.7	10.9	11.1
Net dividend yield (%)	5.8	7.8	8.7	8.9	9.0
Gross dividend yield (%)	8.1	10.8	12.1	12.3	12.6
Imputation (%)	100	100	100	100	100
Pay-out ratio (%)	61	88	128	103	105

Capital Structure	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Interest cover EBIT (x)	6.7	6.1	5.0	6.4	6.9
Interest cover EBITDA (x)	8.6	8.5	7.6	8.9	9.4
Net debt/ND+E (%)	57.2	55.4	53.8	52.3	50.8
Net debt/EBITDA (x)	1.8	1.9	1.99	1.69	1.60

Key Ratios	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Return on assets (%)	12.4	11.0	9.2	11.3	11.3
Return on equity (%)	24.2	21.5	17.1	22.0	22.4
Return on funds employed (%)	17.4	15.8	12.7	16.2	16.8
EBITDA margin (%)	9.8	8.0	7.5	8.2	8.2
EBIT margin (%)	7.6	5.7	4.9	6.0	6.1
Capex to sales (%)	1.9	1.0	1.8	0.9	1.0
Capex to depreciation (%)	140	85	139	71	73

Operating Performance	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Product volumes (m litres)					
Petrol	1,204	1,165	1,130	1,119	1,106
Diesel - retail	461	454	440	431	421
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**	**4,126**	**4,140**	**4,162**
Supply - industry & export	178	280	95	127	125
Total Fuels	**4,323**	**4,448**	**4,221**	**4,267**	**4,287**
Retail service stations	343	343	340	338	335
Petrol/service station (m litres)	3.75	3.64	3.55	3.53	3.49
Diesel/service station (m litres)	1.34	1.32	1.29	1.27	1.25
Gross profit (NZDm)					
Fuels	685	700	646	663	656
Refining	77	54	58	68	66
Non-fuels	76	81	85	87	90
Flick Electric	-	1	7	9	11
Gross profit	**838**	**836**	**796**	**827**	**822**
Fuels gross margin (cpl)	16.5	16.8	15.7	16.0	15.8
Fuels margin incl refining (cpl)	17.6	17.0	16.7	17.1	16.8
Fuels margin excl supply (cpl)	18.3	18.0	17.1	17.6	17.3
Non-fuels revenue/station (NZD 000)	373	398	418	435	446
Refining volume (m barrels)	21.3	19.7	21.2	21.2	21.1
Sales sourced from refinery (%)	82	75	82	81	81
ZEL refining margin (USD/barrel)	8.6	6.2	5.9	7.0	7.0
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

1H20 Forecast

Figure 1. 1H20 forecast

Six months to 30 Sept ($m)	1H19	1H20F	% Diff
Revenue	2,680	2,306	-14%
Gross Profit	**366**	**369**	**1%**
Gross Margin	13.7%	16.0%	17%
Operating costs	(191)	(205)	8%
Operating EBITDAF	**175**	**163**	**-7%**
Depreciation & Amortisation	(57)	(65)	14%
EBIT	**118**	**98**	**-17%**
Net Interest	(26)	(25)	-5%
Other	(3)	-	-100%
Pre-tax profit	**89**	**73**	**-18%**
Tax expense	(17)	(21)	21%
NPAT	**72**	**53**	**-27%**
Minority interest/abnormal	2	5	
Normalised Profit	**74**	**58**	**-22%**
Earnings per share (cps)	18.5	14.4	-22%
Dividend (cps)	12.5	14.0	12%
Key operating assumptions			
Volumes sold (m litres)			
Petrol	560	544	-3%
Diesel - Retail	223	212	-5%
Diesel - Commercial	397	397	0%
Other	538	537	0%
Supply - domestic	252	257	2%
Supply - industry & export	227	34	-85%
Total fuel volumes (m litres)	***2,197***	***1,981***	***-10%***
Gross fuels margin (cpl)	15.3c	15.5c	1%
GM incl refining (cpl)	16.5c	16.7c	1%

Source: Forsyth Barr analysis

Investment summary

Our rating is NEUTRAL. Whilst ZEL entices investors with a very attractive dividend yield, challenges in the retail market and the overshadowing of the ComCom Fuel Study means further earnings and therefore dividend downside cannot be ruled out. We believe ZEL once again has to demonstrate to the market it is able to deliver sustainable earnings, preferably with less volatility than the past two years.

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 with retail competition intensifying, are becoming increasingly volatile. Commercial margins remain stable.
- **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.
- **Strategy 3.0:** ZEL has guided to earnings growth of +$35m to +$40m above underlying FY17 earnings. Growth is predominantly coming from extra Caltex/Z merger benefits and jet fuel being repriced to import parity.

Financial structure

- **Dividend growth:** ZEL has significant free cash flow. We anticipate the FY20 dividend will be 48cps, which still allows for some debt repayment. ZEL is targeting net debt/EBITDAF of 1.6x–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 2. Sales volumes

Source: Forsyth Barr analysis

Figure 3. Fuels gross margin

Source: Forsyth Barr analysis

Figure 4. Substantial Shareholders

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

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

Figure 5. 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$5.53**	**NZ$2,212**	**14.8x**	**11.6x**	**8.1x**	**7.4x**	**12.4x**	**10.2x**	**8.9%**
Suburban Propane Partners LP	SPH US	US$23.13	US$1,428	17.4x	15.9x	9.3x	9.1x	16.7x	17.1x	10.8%
World Fuel Services Corp	INT US	US$39.34	US$2,572	16.0x	13.2x	7.8x	7.3x	10.0x	9.4x	n/a
Contact Energy *	CEN NZ	NZ$8.55	NZ$6,137	23.9x	23.5x	14.8x	14.6x	25.7x	25.0x	4.6%
Mercury *	MCY NZ	NZ$5.46	NZ$7,438	30.4x	27.7x	16.7x	16.3x	27.5x	26.6x	2.9%
Trustpower *	TPW NZ	NZ$8.48	NZ$2,654	25.3x	24.8x	15.3x	15.0x	19.4x	18.8x	4.1%
Meridian Energy *	MEL NZ	NZ$5.40	NZ$13,840	28.8x	30.8x	18.5x	19.5x	29.2x	32.0x	4.0%
Genesis Energy *	GNE NZ	NZ$3.40	NZ$3,480	22.1x	18.9x	12.7x	11.8x	29.4x	25.6x	5.2%
Caltex Australia	CTX AT	A$27.16	A$6,782	19.1x	13.7x	9.4x	7.7x	14.4x	11.2x	4.3%
Viva Energy Group	VEA AT	A$1.89	A$3,665	n/a	14.5x	10.1x	8.6x	17.6x	13.3x	4.5%
			Compco Average:	**22.9x**	**20.3x**	**12.7x**	**12.2x**	**21.1x**	**19.9x**	**5.1%**
EV = Current Market Cap + Actual Net Debt			**ZEL Relative:**	**-35%**	**-43%**	**-36%**	**-40%**	**-41%**	**-49%**	**+75%**

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

Figure 6. Consensus EPS Momentum

Source: Forsyth Barr analysis, Bloomberg

Figure 7. 12 Month Forward PE

Source: Forsyth Barr analysis

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