Z Energy

NEUTRAL

Downgrade Haunts 1H20 Result

Z Energy (ZEL) reported a soft 1H20 result with EBITDAF of $183m, -$7m lower than the pcp after backing out the IFRS 16 non-cash benefit. With the pcp also a soft result, it puts some context around how poor the 1H20 performance has been. That said, the weak result was expected given the September 2019 downgrade. Further earnings cuts have resulted in us lowering our target price -20cps.

What's changed?

- **Earnings:** FY20/FY21 EBITDAF -$8m/-$22m lower to $396m/$420m
- **Target Price:** Reduced -20cps to $5.20
- **Rating:** NEUTRAL rating retained

1H20 result soft as expected

ZEL has reported 1H20 EBITDAF of $183m. The result is slightly better than expected (+$5m), but is -$7m lower than the pcp on a like-for-like basis (i.e. before IFRS 16 changes). FY19 was hurt by one-off factors (refinery outage and rising crude prices), whereas FY20 is all about challenging retail conditions that are yet to dissipate. In addition to the weak operating result, ZEL has written off -$35m of its $46m investment in Flick – not a great surprise as the price ZEL paid always looked high. Nevertheless, writing-off 76% of the purchase price one year after acquisition is not a good look.

Trading update provides no cause for comfort

ZEL indicated that whilst September was better than August, October was worse than September. In other words, whilst trading conditions have improved from August's nadir, the upwards momentum has not continued. ZEL has indicated to achieve FY20 EBITDAF guidance there needs to be an improvement in retail margins and if retail conditions do not improve, FY20 earnings are likely to be towards the bottom of its $390m to $430m EBITDAF guidance range. In our view there is more downside risk than upside risk to FY20 earnings.

Dividend signal is strong, but ZEL faces stock overhang for some time yet

The one positive from the result is ZEL's confidence of being able to pay at least a FY20 48cps dividend, with the fully imputed interim dividend of 16.5cps consistent with a 35%/65% 1H/2H dividend split. A cash yield of 9.0% appears very attractive, however, we believe the disappointments of the last two years mean there is now a significant stock overhang. In addition, any more earnings disappointments and ZEL will have to move below the bottom of the guidance range 48cps dividend.

FY20 forecast cut again and more cautious on longer-term outlook

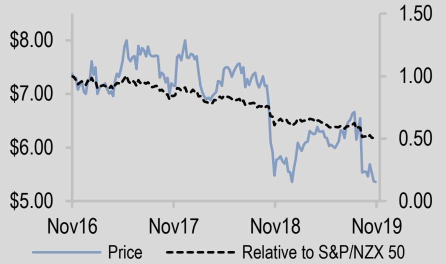
Our underlying (i.e. excl IFRS 16 effects) FY20 EBITDAF forecast is down -$8m to $396m and that has flowed through into later years as we take a more cautious approach to the retail outlook. In addition, opex was higher than expected. We have lowered our target price -20cps given the earnings cuts and continued downside risk.

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 has to demonstrate it can deliver sustainable earnings.

NZX Code	ZEL
Share price	NZ$5.36
Target price	NZ$5.20
Risk rating	Medium
Issued shares	400.0m
Market cap	NZ$2,144m
Average daily turnover	928.3k (NZ$5,538k)

Share Price Performance



Financials: March	19A	20E	21E	22E
NPAT* (NZ$m)	195.8	153.9	164.2	164.4
EPS* (NZc)	49.0	38.5	41.0	41.1
EPS growth* (%)	-7.4	-21.4	6.7	0.1
DPS (NZc)	43.0	48.0	48.0	48.0
Imputation (%)	100	100	100	100

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	6.6	7.5	7.4	7.5
EV/EBIT	9.2	12.0	11.1	11.2
PE	10.9	13.9	13.1	13.0
Price / NTA	9.2	42.8	32.2	n/a
Cash dividend yield (%)	8.0	9.0	9.0	9.0
Gross dividend yield (%)	11.1	12.4	12.4	12.4

*Historic and forecast numbers based on underlying profits

Andrew Harvey-Green
andrew.harvey-green@forsythbarr.co.nz
+64 4 495 8185

Forsyth Barr

Z Energy (ZEL) Priced as at 31 Oct 2019: NZ$5.36 March year end

Forsyth Barr valuation			
Valuation methodology			Blend of spot valuations
12-month target price (NZ$)*	**5.20**	**Spot valuations (NZ$)**	
Expected share price return	-3.0%	1. DCF	5.07
Net dividend yield	9.0%	2. Dividend Yield	5.33
Estimated 12-month return	6.0%	3. Market Multiple	5.30
Key WACC assumptions		**DCF valuation summary (NZ$m)**	
Risk free rate	2.00%	Total firm value	3,032
Equity beta	0.84	(Net debt)/cash	906
WACC	7.1%	Value of equity	2,043
Terminal growth	-2.0%	Shares (m)	400

Profit and Loss Account (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Sales revenue	4,570	5,450	5,168	5,169	5,079
Normalised EBITDA	**448**	**435**	**396**	**420**	**413**
Depreciation and amortisation	(102)	(122)	(147)	(141)	(137)
Normalised EBIT	**347**	**312**	**248**	**279**	**276**
Net interest	(52)	(51)	(64)	(63)	(59)
Associate income	1	(1)	(1)	-	-
Tax	(82)	(61)	(49)	(60)	(61)
Minority interests	-	(2)	(19)	(9)	(8)
Normalised NPAT	**211**	**196**	**154**	**164**	**164**
Abnormals/other	(6)	(16)	(35)	-	-
Reported NPAT	**205**	**180**	**119**	**164**	**164**
Normalised EPS (cps)	52.9	49.0	38.5	41.0	41.1
DPS (cps)	32.3	43.0	48.0	48.0	48.0

Growth Rates	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Revenue (%)	18.3	19.3	-5.2	0.0	-1.7
EBITDA (%)	6.9	-2.9	-9.0	6.2	-1.6
EBIT (%)	3.3	-10.1	-20.4	12.3	-0.9
Normalised NPAT (%)	8.2	-7.4	-21.4	6.7	0.1
Normalised EPS (%)	8.2	-7.4	-21.4	6.7	0.1
DPS (%)	10.2	33.1	11.6	0.0	0.0

Cash Flow (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EBITDA	**448**	**435**	**396**	**420**	**413**
Working capital change	61	(159)	16	(7)	7
Interest & tax paid	(103)	(161)	(142)	(130)	(128)
Other	(15)	223	(192)	(4)	(4)
Operating cash flow	**391**	**338**	**77**	**279**	**289**
Capital expenditure	(87)	(55)	(88)	(46)	(47)
(Acquisitions)/divestments	18	(28)	36	-	-
Other	12	4	4	6	6
Funding available/(required)	**334**	**259**	**30**	**239**	**248**
Dividends paid	(134)	(152)	(198)	(192)	(192)
Equity raised/(returned)	(2)	(1)	(14)	(14)	(14)
Increase/(decrease) in net debt	**(198)**	**(106)**	**182**	**(33)**	**(42)**

Balance Sheet (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Working capital	196	358	363	370	364
Fixed assets	870	830	806	781	757
Intangibles	750	668	785	733	685
Other assets	134	161	219	219	219
Total funds employed	**1,950**	**2,017**	**2,173**	**2,103**	**2,024**
Net debt/(cash)	824	827	1,065	1,038	1,002
Other non current liabilities	269	270	263	257	249
Shareholder's funds	857	920	844	808	772
Minority interests	-	-	-	-	-
Total funding sources	**1,950**	**2,017**	**2,173**	**2,103**	**2,024**

Valuation Ratios	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EV/EBITDA (x)	6.6	6.6	7.5	7.4	7.5
EV/EBIT (x)	8.6	9.2	12.0	11.1	11.2
PE (x)	10.1	10.9	13.9	13.1	13.0
Price/NTA (x)	17.2	9.2	42.8	32.2	26.7
Free cash flow yield (%)	14.2	13.2	-0.5	10.9	11.3
Net dividend yield (%)	6.0	8.0	9.0	9.0	9.0
Gross dividend yield (%)	8.4	11.1	12.4	12.4	12.4
Imputation (%)	100	100	100	100	100
Pay-out ratio (%)	61	88	125	117	117

Capital Structure	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Interest cover EBIT (x)	6.7	6.1	3.9	4.4	4.7
Interest cover EBITDA (x)	8.6	8.5	6.2	6.7	7.0
Net debt/ND+E (%)	57.2	55.4	63.6	64.1	64.4
Net debt/EBITDA (x)	1.8	1.9	2.69	2.47	2.42

Key Ratios	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Return on assets (%)	12.4	11.0	8.1	9.2	9.3
Return on equity (%)	24.2	21.7	18.4	20.5	21.5
Return on funds employed (%)	17.4	15.8	10.8	12.4	12.8
EBITDA margin (%)	9.8	8.0	7.7	8.1	8.1
EBIT margin (%)	7.6	5.7	4.8	5.4	5.4
Capex to sales (%)	1.9	1.0	1.7	0.9	0.9
Capex to depreciation (%)	140	85	107	57	58

Operating Performance	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Product volumes (m litres)					
Petrol	1,204	1,165	1,136	1,139	1,126
Diesel - retail	461	454	446	438	427
Diesel - commercial	807	812	799	831	846
Diesel - biofuels	-	1	6	14	22
Other fuels	1,153	1,193	1,156	1,171	1,186
Supply - domestic	520	544	551	566	574
Sub-total	**4,145**	**4,168**	**4,094**	**4,159**	**4,180**
Supply - industry & export	178	280	82	102	100
Total Fuels	**4,323**	**4,448**	**4,176**	**4,260**	**4,280**
Retail service stations	343	343	340	336	339
Petrol/service station (m litres)	3.70	3.59	3.52	3.54	3.50
Diesel/service station (m litres)	1.34	1.32	1.31	1.29	1.26
Gross profit (NZDm)					
Fuels	685	700	654	658	653
Refining	77	54	68	72	69
Non-fuels	76	81	76	80	82
Flick Electric	-	1	4	7	9
Gross profit	**838**	**836**	**803**	**816**	**813**
Fuels gross margin (cpl)	16.5	16.8	16.0	15.8	15.6
Fuels margin incl refining (cpl)	17.6	17.0	17.3	17.1	16.9
Fuels margin excl supply (cpl)	18.3	18.0	17.6	17.5	17.3
Non-fuels revenue/station (NZD 000)	373	398	378	397	407
Refining volume (m barrels)	21.3	19.7	20.8	21.2	21.3
Sales sourced from refinery (%)	82	75	81	81	81
ZEL refining margin (USD/barrel)	8.6	6.2	6.9	7.0	7.0
Flick customer numbers (000)	-	20.5	20.2	26.2	31.7

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

Further FY20 downgrades cannot be ruled out

Trading conditions are still tough for ZEL, with September and October continuing to track well below ZEL's initial expectations for FY20, albeit there was some improvement vs. August. The question is whether the improvement is sufficient for ZEL to hit its revised guidance? We estimate that ~-$40m of the -$50m Retail EBITDAF downgrade has been realised to the end of October (-$25m had been realised to the end of August). With October likely to have been the second worst month in FY20, the remaining $10m headroom of the downgrade could be chewed up by the end of November. We estimate that over the past three months Retail EBITDAF has been ~-$9m per month below original expectations.

ZEL indicated that "if Retail margins do not change from the August to October actuals, then this would indicate the bottom of the range, with the mid point dependent on an improvement on recent months".

All other things being equal, to hit the top end of guidance, the last five months need to average ~+$2m above original guidance. The bottom end of the range equates to -$6m below original guidance. Given the run rate miss over the past three months is ~-$9m, to hit the bottom end of guidance requires Retail EBITDAF to "improve" +$3m per month. The issue for ZEL is competitor behaviour will be a critical determinant of its Retail performance i.e. it is outside its control.

Figure 1. Retail EBITDAF performance required to hit revised guidance

	Retail performance vs. original guidance $m	Monthly run-rate $m
Estimated last YTD Retail EBITDAF vs. original guidance	**-50**	**-4**
Estimated last three month Retail EBITDAF vs. original guidance	**-28**	**-9**
Retail EBITDAF vs. original guidance required to hit top of revised guidance ($430m)	10	2
Retail EBITDAF vs. original guidance required to hit top of revised guidance ($410m)	-10	-2
Retail EBITDAF vs. original guidance required to hit top of revised guidance ($400m)	-30	-6

Source: Forsyth Barr analysis

Yield looks attractive, but beware the value trap

With ZEL keen to pay at least a 48cps dividend, it is currently trading on a cash yield of 9.0%. Whilst ZEL is attractive on a yield basis and the current share price could be justified even with lower earnings, at present the market lacks confidence in the sustainability of ZEL's earnings. Whilst logic would suggest continued low margins will lead to industry rationalisation, allowing margins to improve over time, there is limited evidence that rationalisation is occurring just yet.

Figure 2 below highlights the earnings level and retail margin required to support a sustainable dividend. The issue is that ZEL's earnings risk is asymmetric to the downside.

Figure 2. Earnings required to support dividend

EBITDAF ($m)	**296**	**307**	**318**	**329**	**340**	**351**	**363**	**374**	**385**	**396**	**407**	**418**	**429**
EBITDAF change ($m)	-100	-89	-78	-67	-56	-44	-33	-22	-11	**0**	11	22	33
Retail margin (cpl)	17.7	18.4	19.1	19.8	20.5	21.2	21.9	22.6	23.3	**24.0**	24.7	25.4	26.1
Retail margin change (cpl)	-6.3	-5.6	-4.9	-4.2	-3.5	-2.8	-2.1	-1.4	-0.7	**0.0**	0.7	1.4	2.1
Dividend (cps)	**30**	**32**	**34**	**36**	**38**	**40**	**42**	**44**	**46**	**48**	**50**	**52**	**54**
Cash dividend yield	5.6%	6.0%	6.3%	6.7%	7.1%	7.5%	7.8%	8.2%	8.6%	**9.0%**	9.3%	9.7%	10.1%
Gross dividend yield	7.8%	8.3%	8.8%	9.3%	9.8%	10.4%	10.9%	11.4%	11.9%	**12.4%**	13.0%	13.5%	14.0%

Source: Forsyth Barr analysis

1H20 result analysis

Figure 3. 1H20 result summary

Six months to 30 Sept ($m)	1H19	1H20	% Diff	Forsyth Barr	$m Diff	Commentary
Revenue	2,680	2,461	-8%	2,306	155	
Gross Profit	**366**	**385**	**5%**	**369**	**16**	Better sales mix & refining contribution boosted the gross profit
Gross Margin	13.7%	15.6%	15%	16.0%	-0.3%	
Operating costs	(191)	(202)	6%	(190)	(12)	IFRS 16 benefit of $15m, so opex +$12m higher than forecast
EBITDAF	**175**	**183**	**5%**	**178**	**5**	Slightly better result than forecast with higher gross margin offset by opex
Depreciation & amortisation	(57)	(74)	30%	(72)	(2)	Up on pcp due to IFRS 16 depreciation ($9m) and Flick amortisation ($8m)
EBIT	**118**	**109**	**-8%**	**106**	**3**	+$3m better than forecast, net of IFRS 16
Net Interest	(26)	(32)	23%	(33)	1	1H20 includes $8m of lease interest costs
Other	(3)	(36)	1100%	-	(36)	Flick write-down of -$35m
Pre-tax profit	**89**	**41**	**-54%**	**73**	**(32)**	
Tax expense	(17)	(19)	12%	(21)	2	
NPAT	**72**	**22**	**-69%**	**53**	**(31)**	
Normalised Profit	**74**	**57**	**-23%**	**58**	**(1)**	
Earnings per share (cps)	18.5	14.3	-23%	14.4	(0.1)	
Dividend (cps)	12.5	16.5	32%	14.0	2.5	ZEL has gone for ~35% 1H split of FY20 48cps dividend guidance
Key operating assumptions						
Volumes sold (m litres)						
Petrol	560	552	-1%	544	8	Slightly better than expected retail volumes in 2Q20 (in Z brand)
Diesel - Retail	223	218	-2%	212	6	Slightly better than expected retail volumes in 2Q20 (in Z brand)
Diesel - Commercial	397	377	-5%	397	-20	Slowing economy impacting on diesel volumes
Other	538	520	-3%	537	-17	
Supply - domestic	252	255	1%	257	-2	
Supply - industry & export	227	26	-89%	34	-8	
Total fuel vol (m litres)	***2,197***	***1,948***	***-11%***	***1,981***	***-33***	
Gross fuels margin (cpl)	15.3c	16.3c	7%	15.5c	0.8c	Stronger than expected margin - mix a key factor
GM incl refining (cpl)	16.5c	18.0c	9%	16.7c	1.4c	Stronger than expected refining contribution

Source: ZEL, Forsyth Barr analysis

Note: We have adjusted our forecast estimates for the IFRS 16 changes for comparability purposes

Key points:

- 1H20 EBITDAF of $183m was in fact -$7m below the pcp after adjusting for +$15m of IFRS 16 benefits.
- 1H19 was a weak result due to the refinery outage and rising crude oil prices creating a temporary headwind. These issues were one-off in nature and reversed in 2H19. The 1H20 result is weaker than the pcp and could continue into the foreseeable future.
- The gross fuels margin of 16.3cpl is up on the pcp, but the above issues manifested themselves in the gross margin, so the pcp figure of 15.3cpl does not give a true picture of underlying margins.
- Non-fuels gross margin was surprisingly down -$2m due to the sale of an asset with $2m of non-fuel revenue attached to it.
- Retail volumes continue to be soft, but did come in slightly ahead of expectations.
- Commercial volumes are being impacted by slowing economic activity and the loss of some significant (low margin) contracts.
- Opex was up +$26m on the pcp (after stripping out IRS 16 benefit). The increase is due to:
  - Flick operating costs (mainly staff)
  - Increased marketing costs (+$10m)
  - Increased professional fees (+$4m)

- The Flick investment write-off of -$35m (vs. acquisition cost of $46m) is very disappointing, albeit unfortunately not that surprising from our perspective.
- The fully imputed interim dividend of 16.5cps is ~35% of the low end of the current FY20 dividend guidance range. This demonstrates a degree of confidence from management it can stay within its earnings guidance range, although we believe there is still some downside risk.
- Whilst FY20 EBITDAF guidance is unchanged, we note that the adoption of IFRS 16 will increased EBITDAF ~+$5m more than previously indicated. There is therefore an implicit -$5m downgrade in underlying earnings guidance (although in our view that is within normal estimation error).
- Despite the weak earnings result, ZEL repaid $20m of debt, although that was enabled by asset sales.

FY20 forecast changes

We have lowered our FY20 EBITDAF forecast with increased opex being a key factor. In addition we are being more cautious on retail margins given ZEL's September and October trading commentary. The other key changes relate to the incorporating IFRS 16 adjustments. These are non-cash adjustments, that we back out for the purposes of calculating our DCF. Whilst our headline FY20 EBITDAF has increased +$22m to $396m, the underlying EBITDAF has declined -$8m. The IFRS 16 and underlying impacts of our forecast changes are shown in Figure 4. Our forecast is now towards the bottom of ZEL's FY20 $390m to $430m EBITDAF guidance range.

The FY20 forecast changes have flowed through to our later year estimates, such that we now assume a flat 48cps dividend profile.

Figure 4. Summary underlying vs. IFRS 16 forecast changes

	FY20 Old $m	IFRS 16 $m	Underlying $m	FY20 New $m	FY21 Old $m	IFRS 16 $m	Underlying $m	FY21 New $m	FY22 Old $m	IFRS 16 $m	Underlying $m	FY22 New $m
Gross profit	800	0	7	807	833	0	(11)	822	828	0	(9)	819
Opex	(427)	30	(15)	(411)	(421)	30	(11)	(402)	(422)	30	(13)	(405)
EBITDAF	**374**	**30**	**(8)**	**396**	**412**	**30**	**(22)**	**420**	**406**	**30**	**(22)**	**413**
Depreciation	(129)	(18)	0	(147)	(113)	(18)	(10)	(141)	(108)	(18)	(11)	(137)
EBIT	**245**	**12**	**(8)**	**249**	**299**	**12**	**(32)**	**279**	**298**	**12**	**(33)**	**276**
Net interest	(49)	(16)	2	(64)	(47)	(16)	(1)	(63)	(43)	(16)	0	(59)
Pre-tax Profit	**196**	**(4)**	**(6)**	**186**	**253**	**(4)**	**(33)**	**216**	**255**	**(4)**	**(33)**	**217**

Source: Forsyth Barr analysis

Figure 5. Forecast changes

	FY20 Old	FY20 New	% Chg	FY21 Old	FY21 New	% Chg	FY22 Old	FY22 New	% Chg
Revenue	4,958	5,168	4%	4,998	5,169	3%	4,919	5,079	3%
Gross profit	**800**	**807**	**1%**	**833**	**822**	**-1%**	**828**	**819**	**-1%**
Gross Margin	16.1%	15.6%	-3%	16.7%	15.9%	-5%	16.8%	16.1%	-4%
Operating costs	(427)	(411)	-4%	(421)	(402)	-5%	(422)	(405)	-4%
EBITDAF	**374**	**396**	**6%**	**412**	**420**	**2%**	**406**	**413**	**2%**
Depreciation & amortisation	(129)	(147)	14%	(113)	(141)	25%	(108)	(137)	27%
EBIT	**245**	**249**	**2%**	**299**	**279**	**-7%**	**298**	**276**	**-7%**
Net Interest	(49)	(64)	29%	(47)	(63)	36%	(43)	(59)	37%
Other	-	(38)		-	-		-	-	
Pre-tax profit	**196**	**148**	**-24%**	**253**	**216**	**-15%**	**255**	**217**	**-15%**
Tax expense	(55)	(49)	-10%	(71)	(60)	-15%	(71)	(61)	-15%
NPAT	**141**	**98**	**-30%**	**182**	**155**	**-15%**	**183**	**156**	**-15%**
Minority interest	9	19	105%	8	9	11%	7	8	13%
NPAT post-minorities	**150**	**117**	**-22%**	**190**	**164**	**-14%**	**190**	**164**	**-14%**
Normalised Profit	**150**	**154**	**3%**	**190**	**164**	**-14%**	**190**	**164**	**-14%**
Earnings per share (eps)	37.5	38.5	3%	47.5	41.0	-14%	47.6	41.1	-14%
Dividend (cps)	48.0	48.0	0%	49.0	48.0	-2%	50.0	48.0	-4%
Key operating assumptions									
Petrol	1,130	1,136	1%	1,119	1,139	2%	1,106	1,126	2%
Diesel - Retail	440	446	1%	431	438	2%	421	427	1%
Diesel - Commercial	823	799	-3%	837	831	-1%	853	846	-1%
Diesel - Biofuels	7	6	-14%	15	14	-7%	23	22	-4%
Jet	879	870	-1%	897	897	0%	910	910	0%
Marine	158	154	-2%	132	132	0%	133	133	0%
Bitumen & Other	136	131	-3%	142	142	0%	143	143	0%
Domestic supply	553	551	0%	566	566	0%	574	574	0%
ZEL specific volumes (m litres)	***4,126***	***4,094***	***-1%***	***4,140***	***4,159***	***0%***	***4,162***	***4,180***	***0%***
Industry and export supply	95	82	-14%	127	102	-20%	125	100	-20%
Total fuel volumes (m litres)	***4,221***	***4,176***	***-1%***	***4,267***	***4,260***	***0%***	***4,287***	***4,280***	***0%***
GM excl supply (cpl)	15.7	16.0	2%	16.0	15.8	-1%	15.8	15.6	-1%
GM incl refining (cpl)	17.1	17.6	3%	17.6	17.5	-1%	17.3	17.3	0%
Gross profit make-up									
Fuels gross profit	646	654	1%	663	658	-1%	656	653	0%
Refining gross profit	58	68	17%	68	72	5%	66	69	5%
Non-fuel gross profit	85	76	-10%	87	80	-9%	90	82	-9%
NZR dividend	4	4	1%	6	6	0%	6	6	0%
Flick gross profit	7	4	-38%	9	7	-20%	11	9	-18%
	800	**807**	**1%**	**833**	**822**	**-1%**	**828**	**819**	**-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.

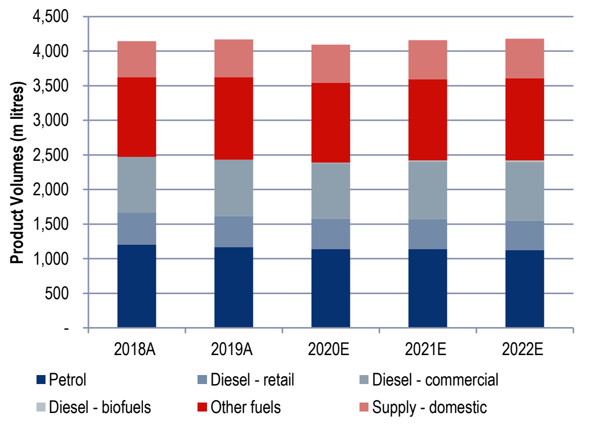
Key risks

- **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

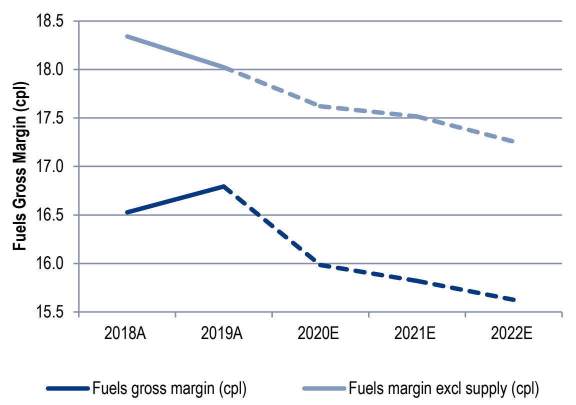
Z Energy is a downstream oil company. Its products include petrol, diesel, marine fuel oil and aviation fuel. Z retails petrol and diesel through a network of ~200 Z branded service stations and ~140 Caltex branded service stations. It sells fuel to the commercial market, which includes a network of 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 6. Fuel volumes



Source: ZEL, Forsyth Barr analysis

Figure 7. Fuels gross margin



Source: ZEL, Forsyth Barr analysis

Figure 8. 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%

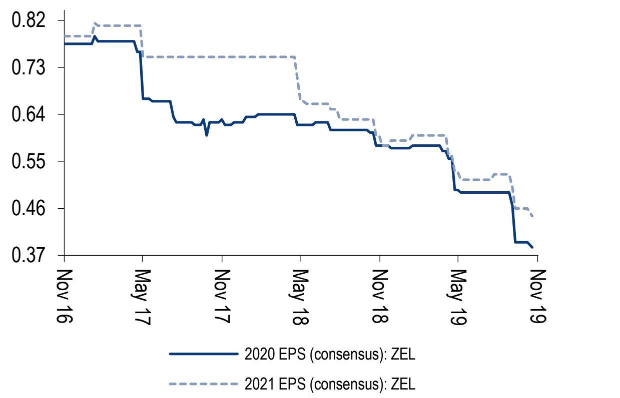
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 9. 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$5.36**	**NZ$2,144**	**13.9x**	**13.1x**	**7.5x**	**7.1x**	**12.0x**	**10.7x**	**9.0%**
Suburban Propane Partners LP	SPH US	US$23.76	US$1,467	17.6x	15.9x	9.5x	9.2x	16.9x	17.3x	10.5%
World Fuel Services Corp	INT US	US$38.78	US$2,537	15.8x	13.0x	7.7x	7.3x	9.9x	9.3x	n/a
Contact Energy *	CEN NZ	NZ$7.48	NZ$5,369	20.9x	20.5x	13.2x	13.0x	22.9x	22.3x	5.3%
Mercury *	MCY NZ	NZ$5.04	NZ$6,859	28.0x	25.6x	15.6x	15.2x	25.7x	24.8x	3.2%
Trustpower *	TPW NZ	NZ$8.35	NZ$2,613	24.8x	24.1x	15.1x	14.7x	19.0x	18.4x	4.2%
Meridian Energy *	MEL NZ	NZ$4.65	NZ$11,918	24.8x	26.5x	16.2x	17.1x	25.5x	28.0x	4.7%
Genesis Energy *	GNE NZ	NZ$3.22	NZ$3,296	20.9x	17.9x	12.2x	11.3x	28.2x	24.6x	5.5%
Caltex Australia	CTX AT	A$27.74	A$6,927	19.5x	13.9x	9.5x	7.8x	14.7x	11.3x	4.3%
Viva Energy Group	VEA AT	A$2.03	A$3,947	n/a	15.9x	10.4x	9.1x	17.7x	14.1x	4.1%
			Compco Average:	**21.5x**	**19.3x**	**12.2x**	**11.6x**	**20.1x**	**18.9x**	**5.2%**
EV = Current Market Cap + Actual Net Debt			**ZEL Relative:**	**-35%**	**-32%**	**-38%**	**-39%**	**-40%**	**-44%**	**+72%**

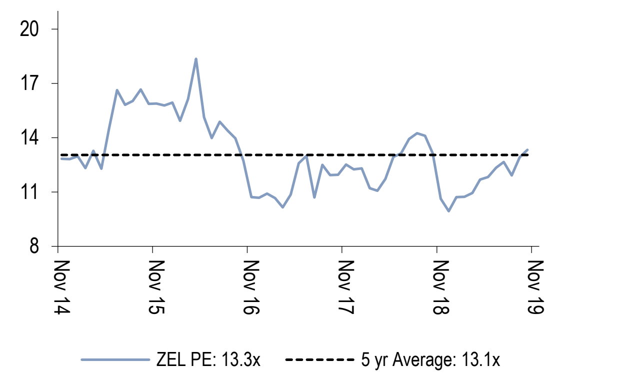
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (ZEL) companies fiscal year end

Figure 10. Consensus EPS Momentum



Source: Forsyth Barr analysis, Bloomberg

Figure 11. 12 Month Forward PE



Source: Forsyth Barr analysis