

Z Energy

NEUTRAL

Risk Ratchets Down, Slightly

The Commerce Commission's (ComCom) final Retail Fuel Market Study report has found that the sector is overearning and its key recommendation is the implementation of terminal gate pricing (TPG). These findings were fully expected. The Government has indicated that it plans to implement most, if not all, of the ComCom's recommendations and hopes to have enabling legislation completed by the middle of 2020. In our view, the findings reduce regulatory risk and our main concern is current retail market competition (which has a degree of irony).

What's changed?

- **EBITDAF, target price & rating:** Unchanged - \$389m, \$5.11 & NEUTRAL

Regulatory risk reduced

The ComCom's findings and recommendations were expected. The only notable change from the draft report was recommending the introduction of TGP instead of opening up the industry "borrow & loan" arrangements. It has also recommended that supplier/distributor contracts be non-exclusive and the contract length shortened. In essence, all of the ComCom's recommendations were part of ZEL's submission and three out of the four largest fuel retailers advocated for TGP. Whilst the ComCom believes the opening up of the wholesale market will improve retail competition (and lower retail fuel prices), we are less convinced.

Political risk also down, sort of

The Government has quickly come out and accepted the ComCom's findings. Whilst it still has to go to Cabinet, indications are that the Government will look to implement the ComCom's recommendations. That is a positive as it removes the risk of the Government doing something different. There are two caveats though. First, the Government wants to pass legislation by the middle of next year, which is very quick and runs the risk of poor legislation and a shortened consultation period. Second, the Government has high expectations that the recommendation will significantly lower pump prices — we are not convinced.

Retail risk remains

In our view, retail market competition is doing a very good job lowering retail prices at present. ZEL confirmed today that retail trading conditions remain very tough which, heading into New Zealand's main holiday season, is of concern.

We estimate that at present the retail performance is between -\$45m and -\$50m below original guidance. If conditions do not improve the current trajectory suggests the retail EBITDAF will be ~-\$80m below original guidance or ~-5cpl, equating to FY20 EBITDAF of ~\$380m, -\$10m below the bottom of the updated guidance range. We estimate that the current share price assumes an additional permanent reduction in the retail margin of between -3cpl and -4cpl. Whilst it is our view that the market is overly negative, until the retail market shows signs of improvement, it is hard to see a catalyst for a material positive re-rating as further earnings downgrades cannot be ruled out.

Investment View

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

NZX Code	ZEL
Share price	NZ\$4.92
Target price	NZ\$5.11
Risk rating	Medium
Issued shares	400.0m
Market cap	NZ\$1,968m
Average daily turnover	848.9k (NZ\$5,064k)

Share Price Performance



Financials: March	19A	20E	21E	22E
NPAT* (NZ\$m)	195.8	148.6	164.0	164.2
EPS* (NZc)	49.0	37.1	41.0	41.1
EPS growth* (%)	-7.4	-24.1	10.4	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	6.2	7.2	7.0	7.1
EV/EBIT	8.6	11.6	10.5	10.6
PE	10.0	13.2	12.0	12.0
Price / NTA	8.4	44.0	32.2	n/a
Cash dividend yield (%)	8.7	9.8	9.8	9.8
Gross dividend yield (%)	12.1	13.6	13.6	13.6

*Historic and forecast numbers based on underlying profits

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Z Energy (ZEL)

Priced as at 05 Dec 2019: NZ\$4.92

March year end

Forsyth Barr valuation					Valuation Ratios						
Valuation methodology					Blend of spot valuations						
12-month target price (NZ\$)*					Spot valuations (NZ\$)						
Expected share price return	3.9%	1. DCF	4.93	EV/EBITDA (x)	6.2	6.2	7.2	7.0	7.1		
Net dividend yield	9.8%	2. Dividend Yield	5.33	EV/EBIT (x)	8.0	8.6	11.6	10.5	10.6		
Estimated 12-month return	13.6%	3. Market Multiple	5.21	PE (x)	9.3	10.0	13.2	12.0	12.0		
				Price/NTA (x)	15.7	8.4	44.0	32.2	26.4		
				Free cash flow yield (%)	15.4	14.4	-0.8	11.8	12.3		
				Net dividend yield (%)	6.6	8.7	9.8	9.8	9.8		
				Gross dividend yield (%)	9.1	12.1	13.6	13.6	13.6		
				Imputation (%)	100	100	100	100	100		
				Pay-out ratio (%)	61	88	129	117	117		
Key WACC assumptions					DCF valuation summary (NZ\$m)						
Risk free rate	2.00%	Total firm value	3,045	Capital Structure							
Equity beta	0.84	(Net debt)/cash	906	2018A	2019A	2020E	2021E	2022E			
WACC	7.1%	Value of equity	2,056	Interest cover EBIT (x)	6.7	6.1	3.8	4.4	4.7		
Terminal growth	-2.0%	Shares (m)	400	Interest cover EBITDA (x)	8.6	8.5	6.1	6.6	7.0		
				Net debt/ND+E (%)	57.2	55.4	63.9	64.5	64.8		
				Net debt/EBITDA (x)	1.8	1.9	2.76	2.48	2.44		
Profit and Loss Account (NZ\$m)					Key Ratios						
Sales revenue	4,570	5,450	5,166	2018A	2019A	2020E	2021E	2022E			
Normalised EBITDA	448	435	389	2021E	2022E	Return on assets (%)	12.4	11.0	7.8	9.2	9.3
Depreciation and amortisation	(102)	(122)	(147)	(141)	(137)	Return on equity (%)	24.2	21.7	17.9	20.7	21.6
Normalised EBIT	347	312	241	279	276	Return on funds employed (%)	17.4	15.8	10.5	12.4	12.8
Net interest	(52)	(51)	(64)	(63)	(59)	EBITDA margin (%)	9.8	8.0	7.5	8.1	8.1
Associate income	1	(1)	(1)	-	-	EBIT margin (%)	7.6	5.7	4.7	5.4	5.4
Tax	(82)	(61)	(47)	(60)	(61)	Capex to sales (%)	1.9	1.0	1.7	0.9	0.9
Minority interests	-	(2)	(19)	(9)	(8)	Capex to depreciation (%)	140	85	107	57	58
Normalised NPAT	211	196	149	164	164	Operating Performance					
Abnormals/other	(6)	(16)	(35)	-	-	2018A	2019A	2020E	2021E	2022E	
Reported NPAT	205	180	114	164	164	Product volumes (m litres)					
Normalised EPS (cps)	52.9	49.0	37.1	41.0	41.1	Petrol	1,204	1,165	1,136	1,139	1,126
DPS (cps)	32.3	43.0	48.0	48.0	48.0	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)	3.64	3.53	3.45	3.48	3.44
						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	63	72	69
						Non-fuels	76	81	76	80	82
						Flick Electric	-	1	4	7	9
						Gross profit					
						838	836	798	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	17.2	17.1	16.9
						Fuels margin excl supply (cpl)	18.3	18.0	17.5	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	6.4	7.0	7.0
						Flick customer numbers (000)	-	20.5	20.2	26.2	31.7
Balance Sheet (NZ\$m)											
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	1,071	1,044	1,008						
Other non current liabilities	269	270	263	257	249						
Shareholder's funds	857	920	839	802	766						
Minority interests	-	-	-	-	-						
Total funding sources	1,950	2,017	2,173	2,103	2,024						

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

ComCom findings & recommendations

The ComCom's key findings were:

- Fuel companies have been making persistently higher profits over the past decade than would be expected in a competitive market and whilst recognising recent trading conditions, the ComCom does not believe there would be any change without regulation.
- Discounts and loyalty schemes avoid direct price competition.
- Premium petrol margins have risen faster than regular petrol margins.
- The core issues are in the wholesale market:
 - There is no active wholesale market due to the long-term exclusive nature of the supplier/distributor contracts limiting the ability for distributors to switch suppliers.
 - Wholesale prices are higher than the ComCom would expect in a competitive market.

Whilst some of the ComCom's analysis can be debated, the reality is it was never going to materially alter its draft findings, hence, these findings were of no surprise. Nevertheless, it was quick to dismiss recent retail trading conditions — a case of too little, too late.

Its recommendations address each of the above findings.

The key recommendations are:

- Implementing a terminal gate pricing (TGP) regime. In essence the aim is to create a liquid wholesale market, where distributors can pick up fuel at any terminal at the stated price. It is intended that TGP can work alongside the current borrow and loan arrangements. The aim is to:
 - Lower barriers of entry and expansion for distributors
 - Provide greater price transparency for wholesale customers who currently don't know if they are getting a good deal or not
 - Provide information to industry and government
- Regulate wholesale supply contracts by limiting the use of long-term exclusive supply contracts.
- Require retailers to display premium fuel prices on its display boards (ZEL has already made orders for additional price boards at a total cost of ~\$2m).
- Increase monitoring of prices, including discounting and loyalty practises.

The ComCom has also indicated there needs to be the credible threat of further regulatory action, suggesting either a backstop binding arbitration system or some form of default regulatory wholesale pricing.

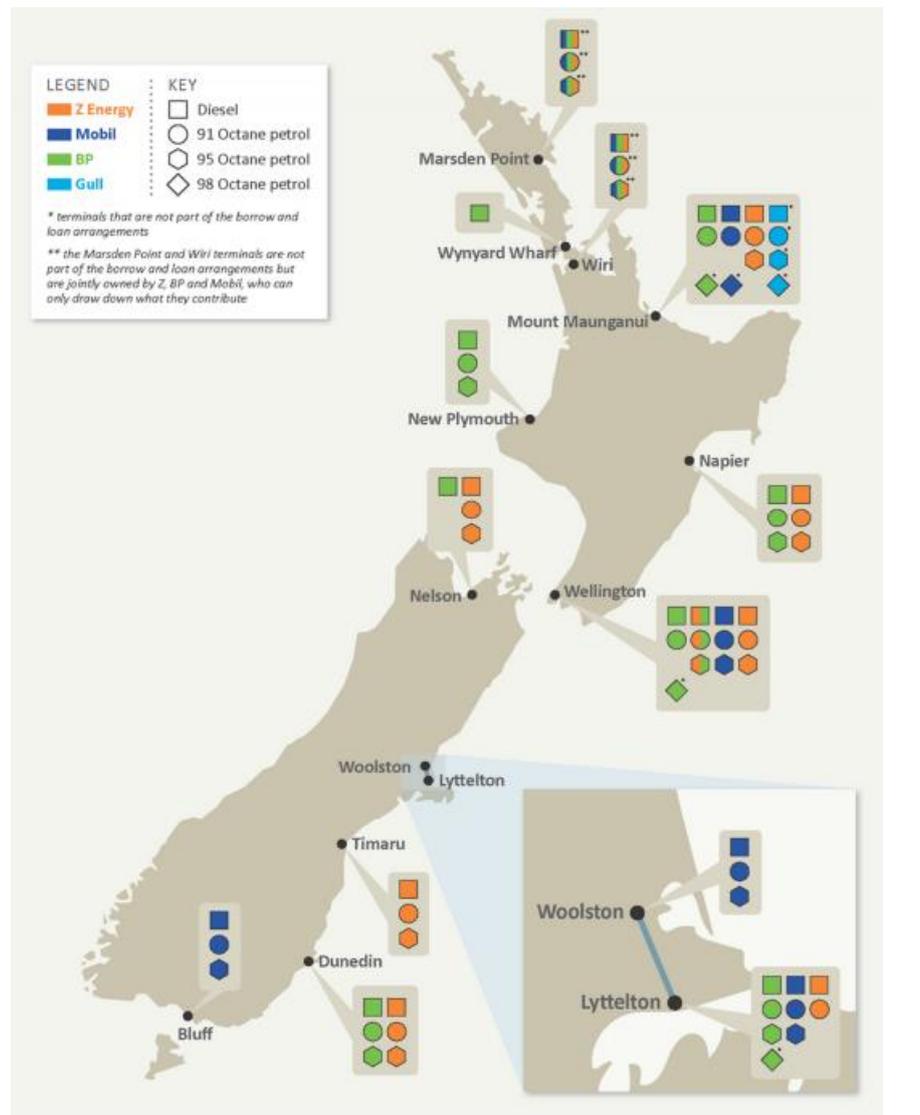
ZEL believes it is competitively advantaged

ZEL owns the most terminal infrastructure

ZEL has more infrastructure than any other player in the market. It, therefore, believes it now has a greater opportunity to leverage that position. It appears likely that ZEL will withdraw its Nelson terminals from the "borrow and loan" system, forcing all of the other market participants to pay a market price for using that terminal (which presumably would be consistent with a TGP at that terminal).

However, we do not expect it to all work in ZEL's favour. Mobil (at Bluff) and BP (at New Plymouth) both have exclusive terminals, albeit it is easier to service Southland and Taranaki from alternative ports vs. Nelson which would require trucking fuel from Christchurch.

Figure 1. Terminal storage in New Zealand



Source: Commerce Commission

Less supply contract volumes

ZEL has less contracted supply volumes at risk to wholesale competition than Mobil or BP. It, therefore, has more opportunity than risk by being able to compete for these volumes. In addition, the ComCom accepts that where there is a close strategic relationship that involves investment by the supplier into the distributor, there are grounds for relaxing the exclusive supply rules. ZEL’s supply of Challenge (via Farmlands) is an example of such a contract and accounts for 83 sites, arguably improving its relative competitive position.

Figure 2. Distributors supplied by the big three suppliers

	Z	BP	Mobil
Distributor brands	3	3	3
Distributor sites	127	155	229

Source: ComCom, Forsyth Barr analysis

Note: BP supplies two brands and 25 sites in which it has a 49% ownership stake. In addition, the ComCom has not treated Foodstuffs as a distributor.

Lower premium fuel margin

ZEL indicated that its premium 95 octane petrol is priced on average +8cpl above 91 octane petrol compared to a market average of +13cpl. The display of high octane petrol on price boards should, in theory, have less impact on ZEL than its competitors.

We're not convinced there is regulatory downside risk

We are not convinced that opening up the wholesale market will make a material difference to the retail market. Whilst it will be easier for distributors to switch supplier (and there are benefits to distributors), it does not necessarily follow there will be lower prices. When supply contracts are negotiated we expect there is a high degree of competition for that supply at the time.

Second, anecdotal evidence from Australia, upon which the TGP regime will be based, suggests the public disclosure of terminal pricing has little impact on retail prices.

Next steps

The ball is now in the Government's court — and it is looking to move quickly. It has accepted the recommendations (although it has yet to go to Cabinet). Implementing some of the recommendations can be quick, such as the premium price boards. However, implementing TGP should take time.

Ideally, the stages before full implementation include:

- Passing enabling legislation
- Setting up the regulatory body to enact the legislation
- Developing the TGP regime
- Implementing the TGP, including a transition period (recommended by the ComCom)

The Government is looking to move quickly and pass legislation by the middle of 2020. That is a shorter than normal timeframe and runs the risk of a poor quality result. It is clear the Government is keen to pass legislation ahead of the 2020 election.

Nevertheless, implementing a TGP will take time — we would expect it to take two years at a minimum.

Retail trading conditions and FY20 guidance

In our view, the key issue for ZEL remains the retail market and the collapse of retail margins that has taken place since July 2019. ZEL has indicated that the tough conditions have continued, which is concerning when heading into the important Christmas period.

ZEL downgraded its FY20 EBITDAF guidance -\$60m in September, -\$50m of which was attributed to the retail market. We estimate that the year-to-date retail performance is -\$45m to -\$50m below original guidance — i.e. ZEL has already “used” the downgrade, with four months of FY20 to go.

The gap from the mid-point (\$410m) of the guidance range to the bottom of the range (\$390m) is \$20m. With four months remaining in the financial year, we estimate that ZEL has two to three months of headroom in its guidance range if retail trading conditions do not change. If all four months continue to trade at a similar level to the past few months, we estimate ZEL will miss the bottom of its guidance range --\$10m.

Complicating matters are weak gross refining margins. We estimate that is an additional ~-\$7m headwind (\$5m impact on fuel margins and \$2m cut to the NZR, dividend). However, ZEL indicated that the gross refining margin headwind has been offset by gains elsewhere (which it would not elaborate on).

Our FY20 EBITDAF forecast is \$389m, slightly below the bottom of the guidance range and currently it is the low in the market.

In summary, whilst ZEL appears to be offering very good value, we do not yet have the confidence that retail conditions are going to improve to justify a rating upgrade. ZEL's 3Q20 operating statistics and market commentary to be released in mid-late January is, therefore, of greater than normal importance. It is ironic that retail competition is currently a greater value threat than a regulatory process that focussed on the lack of retail competition.

Investment summary

Our rating is **NEUTRAL**. Whilst ZEL entices investors with a very attractive dividend yield, challenges in the retail market means further earnings and therefore dividend downside cannot be ruled out. We believe ZEL has to once again 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.

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.

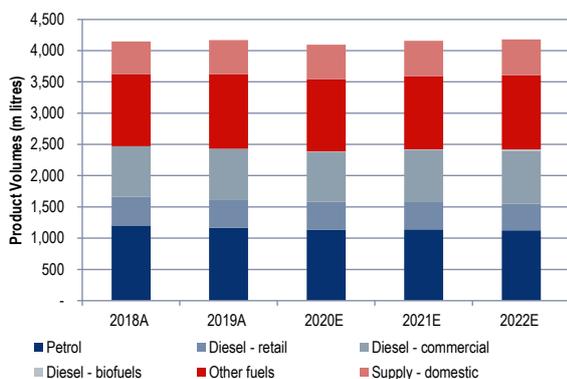
Financial structure

- **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

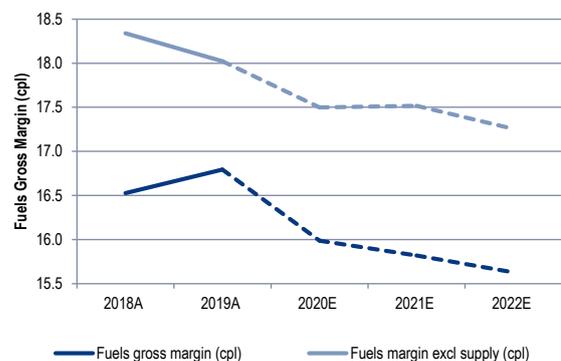
- **Long-term threat to industry volumes:** Increased vehicle efficiency and the threat from electric vehicles will pressure industry volumes. However, the near-term risks are low with industry volumes growing.
- **Retail Fuel Market Study (RFMS):** The RFMS has found that the retail fuel sector is over-earning and that the wholesale market needs opening up via terminal gate pricing. Whilst we do not believe this will have a material impact on sector earnings, it is a risk.

Figure 3. Product volumes



Source: Forsyth Barr analysis

Figure 4. Fuel gross margins



Source: Forsyth Barr analysis

Figure 5. Substantial Shareholders

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

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

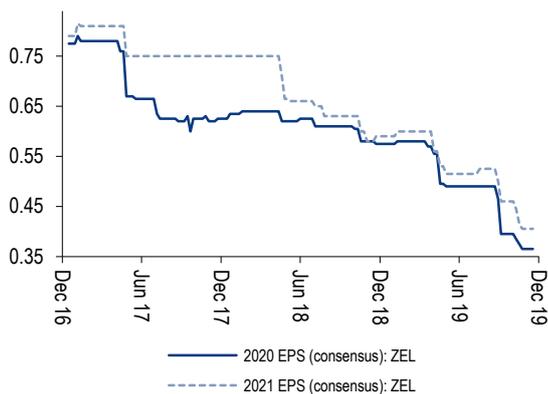
Figure 6. International Compcos

Company	Code	Price	Mkt Cap (m)	PE		EV/EBITDA		EV/EBIT		Cash D/Yld
				2020E	2021E	2020E	2021E	2020E	2021E	2021E
<i>(metrics re-weighted to reflect ZEL's balance date - March)</i>										
Z Energy	ZEL NZ	NZ\$4.92	NZ\$1,968	13.2x	12.0x	7.2x	6.7x	11.6x	10.0x	9.8%
Suburban Propane Partners LP	SPH US	US\$21.89	US\$1,361	17.5x	15.1x	9.3x	9.0x	17.1x	n/a	11.1%
World Fuel Services Corp	INT US	US\$42.63	US\$2,788	16.8x	14.3x	8.2x	7.7x	10.4x	9.9x	n/a
Contact Energy *	CEN NZ	NZ\$7.19	NZ\$5,161	20.1x	20.1x	12.8x	12.7x	22.2x	22.0x	5.5%
Mercury *	MCY NZ	NZ\$4.88	NZ\$6,648	27.0x	24.7x	15.1x	14.8x	24.9x	24.1x	3.3%
Trustpower *	TPW NZ	NZ\$7.15	NZ\$2,238	23.4x	21.9x	13.8x	13.4x	17.1x	16.5x	4.8%
Meridian Energy *	MEL NZ	NZ\$4.89	NZ\$12,533	26.2x	28.6x	17.0x	18.2x	26.9x	30.2x	4.4%
Genesis Energy *	GNE NZ	NZ\$3.15	NZ\$3,243	20.6x	17.5x	12.1x	11.1x	28.1x	24.1x	5.6%
Caltex Australia	CTX AT	A\$34.30	A\$8,565	22.9x	16.6x	10.3x	8.7x	16.4x	12.9x	3.6%
Viva Energy Group	VEA AT	A\$2.17	A\$4,220	n/a	16.9x	10.4x	8.7x	17.7x	13.8x	4.1%
Compcos Average:				21.8x	19.5x	12.1x	11.6x	20.1x	19.2x	5.3%
ZEL Relative:				-39%	-38%	-41%	-43%	-42%	-48%	+85%

EV = Current Market Cap + Actual Net Debt

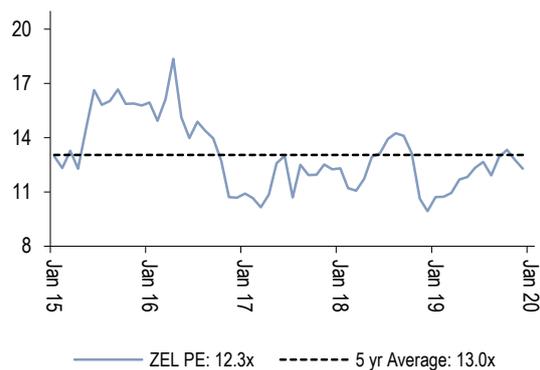
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compcos metrics re-weighted to reflect headline (ZEL) companies fiscal year end

Figure 7. Consensus EPS Momentum



Source: Forsyth Barr analysis, Bloomberg

Figure 8. 12 Month Forward PE



Source: Forsyth Barr analysis

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