

# Z Energy

OUTPERFORM

## Unwanted Black Friday Discount

Z Energy (ZEL) has provided its own Black Friday discount, with the share price reaction to its earnings downgrade providing investors with an unwanted buying opportunity. That said, we don't expect ZEL is on many investors Christmas card list after it downgraded its FY20 EBITDAF guidance range ~-\$45m (10.4%), to \$350m to \$385m. Once again, a tough retail market has been cited as the main issue. Notwithstanding the fact we have cut our target price -43cps (-8.4%) to \$4.68, we upgrade our rating to OUTPERFORM as we believe there is more upside risk than downside.

### What's changed?

- **Earnings:** FY20 EBITDAF cut -\$29m to \$360m, dividend -8cps to 40cps
- **Target Price:** Cut -43cps (-8.4%) to \$4.68
- **Rating:** Upgraded to OUTPERFORM

### Timing and magnitude of downgrade disappointing

A week after assuring investors FY20 EBITDAF was tracking within its \$390m to \$430m guidance range (albeit towards the lower end), ZEL has lowered the range to between \$350m and \$385m — so it doesn't even overlap. Whilst we believed FY20 EBITDAF was under pressure (our FY20 EBITDAF forecast was \$389m), we thought any downgrade would take place in January after the Christmas break, and be -\$20m at most. Once again, ZEL has cited retail market competition — or the lack of a return to "normal" behaviour as the main reason for the downgrade, with low gross refining margins also an issue.

### Opportunity for value hunters prepared to withstand short-term volatility

We believe ZEL is now offering good value to investors, such that we have upgraded our rating to OUTPERFORM. There are several reasons why we believe the upside potential is greater than the downside risk.

- The share price is factoring a further -4cpl to -5cpl decline in retail margins which we view as unlikely
- Retail margins are back to ~2012 levels, which is likely to result in service station closures and slow the rate of expansion of the low-cost networks (albeit that is probably a two year story)
- ZEL has the ability to take cost-out, to date it has focussed on adding value (which has invariably meant adding cost)
- We believe ZEL is now a possible takeover target
- Valuation metrics are better than they appear. We estimate FY20 adjusted PE is 9.0x, falling to 8.7x in FY21

### Downgrades to earnings, dividend and target price

We have cut our FY20 EBITDAF forecast -\$29m to \$360m, with ~50% due to the retail market and ~50% due to lower gross refining margins. Our FY21 EBITDAF forecast is -\$34m lower to \$386m, with the entire cut due to a reduced retail performance. Our target price is now \$4.68, down -8.4%.

### Investment View

Our rating is OUTPERFORM. ZEL is offering investors good value, with the market pricing in additional downside that we do not believe is likely to eventuate. ZEL has yet to pull the cost lever and we expect it is looking attractive as a takeover target.

NZX Code	ZEL
Share price	NZ\$4.23
Target price	NZ\$4.68
Risk rating	Medium
Issued shares	400.0m
Market cap	NZ\$1,692m
Average daily turnover	856.5k (NZ\$5,076k)

### Share Price Performance



Financials: March	19A	20E	21E	22E
NPAT* (NZ\$m)	195.8	128.0	139.1	141.7
EPS* (NZc)	49.0	32.0	34.8	35.4
EPS growth* (%)	-7.4	-34.6	8.7	1.9
DPS (NZc)	43.0	40.0	41.5	43.0
Imputation (%)	100	100	100	100

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	5.6	7.1	6.9	7.0
EV/EBIT	7.7	11.9	10.9	10.9
PE	8.6	13.2	12.2	11.9
Price / NTA	7.2	n/a	35.9	n/a
Cash dividend yield (%)	10.2	9.5	9.8	10.2
Gross dividend yield (%)	14.1	13.1	13.6	14.1

\*Historic and forecast numbers based on underlying profits

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**Z Energy (ZEL)**

Priced as at 13 Dec 2019: NZ\$4.23

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	10.6%	1. DCF	4.48	EV/EBITDA (x)	5.6	5.6	7.1	6.9	7.0		
Net dividend yield	9.7%	2. Dividend Yield	5.05	EV/EBIT (x)	7.2	7.7	11.9	10.9	10.9		
Estimated 12-month return	20.4%	3. Market Multiple	4.52	PE (x)	8.0	8.6	13.2	12.2	11.9		
				Price/NTA (x)	13.5	7.2	70.7	35.9	26.4		
				Free cash flow yield (%)	18.0	16.7	-2.0	12.4	12.9		
				Net dividend yield (%)	7.6	10.2	9.5	9.8	10.2		
				Gross dividend yield (%)	10.6	14.1	13.1	13.6	14.1		
				Imputation (%)	100	100	100	100	100		
				Pay-out ratio (%)	61	88	125	119	121		
Key WACC assumptions					DCF valuation summary (NZ\$m)						
Risk free rate	2.00%	Total firm value	2,867	Capital Structure							
Equity beta	0.84	(Net debt)/cash	906	2018A	2019A	2020E	2021E	2022E			
WACC	7.1%	Value of equity	1,878	Interest cover EBIT (x)	6.7	6.1	3.3	3.8	4.1		
Terminal growth	-2.0%	Shares (m)	400	Interest cover EBITDA (x)	8.6	8.5	5.6	6.0	6.4		
				Net debt/ND+E (%)	57.2	55.4	65.1	65.2	65.4		
				Net debt/EBITDA (x)	1.8	1.9	3.02	2.73	2.66		
Profit and Loss Account (NZ\$m)					Key Ratios						
Sales revenue	4,570	5,450	5,152	2018A	2019A	2020E	2021E	2022E			
Normalised EBITDA	448	435	360	386	382	Return on assets (%)	12.4	11.0	7.0	8.1	8.3
Depreciation and amortisation	(102)	(122)	(147)	(141)	(137)	Return on equity (%)	24.2	21.7	15.8	17.8	18.9
Normalised EBIT	347	312	213	245	245	Return on funds employed (%)	17.4	15.8	9.3	10.9	11.4
Net interest	(52)	(51)	(64)	(64)	(60)	EBITDA margin (%)	9.8	8.0	7.0	7.5	7.6
Associate income	1	(1)	(1)	-	-	EBIT margin (%)	7.6	5.7	4.1	4.8	4.9
Tax	(82)	(61)	(39)	(51)	(52)	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	56	58
Normalised NPAT	211	196	128	139	142	Operating Performance					
Abnormals/other	(6)	(16)	(35)	-	-	2018A	2019A	2020E	2021E	2022E	
Reported NPAT	205	180	93	139	142	Product volumes (m litres)					
Normalised EPS (cps)	52.9	49.0	32.0	34.8	35.4	Petrol	1,204	1,165	1,136	1,139	1,126
DPS (cps)	32.3	43.0	40.0	41.5	43.0	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	641	624	622
						Refining	77	54	49	72	69
						Non-fuels	76	81	76	80	82
						Flick Electric	-	1	4	6	8
						Gross profit					
						838	836	770	782	781	
						Fuels gross margin (cpl)	16.5	16.8	15.6	15.0	14.9
						Fuels margin incl refining (cpl)	17.6	17.0	16.5	16.3	16.2
						Fuels margin excl supply (cpl)	18.3	18.0	16.9	16.8	16.5
						Non-fuels revenue/station (NZD 000)	373	398	378	397	407
						Refining volume (m barrels)	21.3	19.7	20.1	21.2	21.3
						Sales sourced from refinery (%)	82	75	78	81	81
						ZEL refining margin (USD/barrel)	8.6	6.2	5.2	7.0	7.0
						Flick customer numbers (000)	-	20.5	20.0	23.1	29.9
Balance Sheet (NZ\$m)											
Working capital	196	358	361	368	361						
Fixed assets	870	830	806	780	756						
Intangibles	750	668	785	733	685						
Other assets	134	161	219	219	219						
Total funds employed	1,950	2,017	2,171	2,100	2,021						
Net debt/(cash)	824	827	1,090	1,054	1,015						
Other non current liabilities	269	270	263	257	249						
Shareholder's funds	857	920	818	788	756						
Minority interests	-	-	-	-	-						
Total funding sources	1,950	2,017	2,171	2,100	2,021						

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

## Upgrading to OUTPERFORM

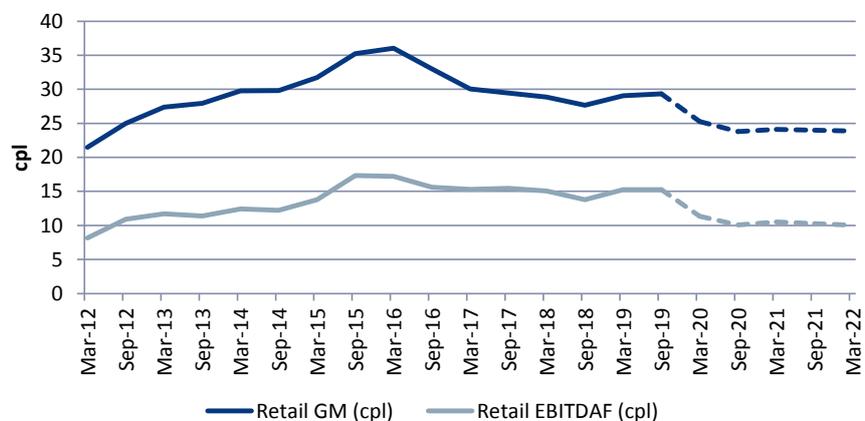
Whilst we have cut our earnings outlook and our target price -43cps (-8.4%) to \$4.68, we believe the market is now factoring in further downside that is highly unlikely. For investors prepared to be patient, we believe ZEL now offers good value.

### Share price is factoring further downside, more than we believe is probable

#### Estimated retail profit margins lower than FY13 and similar to FY12

We estimate that the ZEL FY20 retail EBITDAF margin is lower than FY13 and if current trading conditions remain, will head towards FY12.

Figure 1. Estimated retail gross margin and EBITDAF (cpl)



Source: ZEL, Forsyth Barr analysis

### Share price appears to be factoring in a further -4 to -5cpl decline in retail margins

We estimate that the share price is factoring in a further -4cpl to -5cpl decline in ZEL's retail margins. The mid-point of ZEL's revised EBITDAF guidance range implies a dividend of ~42.5cps under ZEL's dividend policy. ZEL's dividend guidance of 40cps is conservative on our calculations and is the appropriate dividend if ZEL hit the bottom of its EBITDAF revised guidance range. ZEL itself noted that at the middle of the EBITDAF guidance range (\$367.5m), a 40cps dividend would be towards the bottom of the 70% to 85% of free cash flow payout range as per its dividend policy.

Working backwards from a mid-point dividend of 42.5cps, we estimate that if the market had confidence in ZEL's earnings and therefore its dividend, it would trade of a cash dividend yield of ~7% (gross dividend yield ~10%). That is a ~+2.5% cash yield and ~4.0% gross dividend yield premium on the generator/retailers. A sustainable 30cps dividend implies ZEL retail margins have fallen a further -4cpl to -5cpl.

In our view, that kind of earnings fall is unlikely.

Figure 2. Dividend yield and retail margin implications at \$4.23

Retail margin (cpl)	15.5	16.4	17.2	18.1	19.0	19.9	20.7	21.6	22.5	23.4	24.3	25.1
Retail margin change (cpl)	(7.0)	(6.1)	(5.3)	(4.4)	(3.5)	(2.6)	(1.8)	(0.9)	0.0	0.9	1.8	2.6
EBITDAF (\$m)	257	271	285	299	312	326	340	354	368	382	396	410
EBITDAF change (\$m)	(111)	(97)	(83)	(69)	(56)	(42)	(28)	(14)	0	14	28	42
<b>Dividend (cps)</b>	<b>22.5</b>	<b>25.0</b>	<b>27.5</b>	<b>30.0</b>	<b>32.5</b>	<b>35.0</b>	<b>37.5</b>	<b>40.0</b>	<b>42.5</b>	<b>45.0</b>	<b>47.5</b>	<b>50.0</b>
Cash dividend yield	5.3%	5.9%	6.5%	7.1%	7.7%	8.3%	8.9%	9.5%	10.0%	10.6%	11.2%	11.8%
Gross dividend yield	7.4%	8.2%	9.0%	9.9%	10.7%	11.5%	12.3%	13.1%	14.0%	14.8%	15.6%	16.4%

Source: Forsyth Barr analysis

## Retail fuel market reaction to low returns yet to begin

The dramatic drop in retail margins over the past six months (ZEL has indicated a figure of -7cpl), has yet to result in significant investment changes. Low retail margins are likely to have two effects:

- **Result in store closures.** The most exposed are small sites that sell 1.0m–1.5m litres per annum with investment decisions coming up (e.g. tank replacement). Network rationalisation is likely to pick-up speed over the coming two to three years.
- **Result in slower roll-out of new stores.** Gull, Waitomo and NPD have been particularly aggressive rolling out new service stations and expanding into new areas. Whilst we believe these low cost operators are less impacted than the big three, the lower margins must play into decisions about new store roll-outs. However, both Gull and Waitomo are sub-scale in the South Island in particular, so we expect them to roll-out several more stores in the coming years to build out their network.

Closure of sites and the slowing of service station roll-outs will, in time, be beneficial for both volumes and margins, in our view.

## We believe ZEL has the ability to take cost-out

Whilst ZEL has indicated there are ~\$20m of strategy/cost savings offsetting some of the FY20 EBITDAF downgrade, it has alluded to further strategy/cost out work that it is working through. In our view it has little choice. Full service operators are struggling to compete on price, so they need focus more on cost. In our 20 March 2018, report we discuss in more detail ZEL's operating cost structure and the potential for it to lower costs.

ZEL has indicated that it will be updating the market at its FY20 result announcement in May 2020 on the additional strategy/cost-out measures it is working through.

## ZEL is now a potential takeover target

ZEL's precipitous share price decline makes it more interesting as a potential takeover target. In our 2020 Equity Strategy report '*The Year Ahead; Five/Five for 2020*', ZEL screens as the second most attractive takeover target in our coverage universe.

In addition, there has been significant takeover activity in the sector in recent years. Caltex Australia is currently dealing with a takeover attempt and there have been several transactions in the downstream fuel sector in recent years in Australasia, including Shell Australia downstream assets (August 2014), Caltex New Zealand (April 2016), Gull (July 2017), and Woolworths fuel assets (April 2019) in Australia. In our view, there are some natural synergies owning fuel businesses on both sides of the Tasman and we would be surprised if some of the global players active in Australia haven't cast their eyes across to New Zealand.

## Valuation metrics better than they appear at first glance

Figure 2 highlighted the attractiveness of ZEL on a dividend yield basis. In addition, its cash flows are better than some valuation metrics would suggest. In particular, ZEL's headline FY20 PE ratio is 13.2x, falling to 12.2x in FY21. For a business that is under pressure, ZEL does not appear that cheap. However, like the generator/retailers, its maintenance capex of ~\$45m is materially lower than its headline depreciation and amortisation of ~\$125m. As a result, ZEL's adjusted FY20 PE is 9.0x, falling to 8.7x in FY21.

Figure 3. Calculation of adjusted PE

	FY20	FY21	FY22
<b>Headline price/earnings ratio</b>	<b>13.2</b>	<b>12.2</b>	<b>11.9</b>
Headline NPAT	128	139	142
Add depreciation/amortisation (net of tax)	93	89	86
Less maintenance capex (net of tax)	(32)	(33)	(34)
<b>Adjusted NPAT</b>	<b>188</b>	<b>195</b>	<b>194</b>
<b>Adjusted PE</b>	<b>9.0</b>	<b>8.7</b>	<b>8.7</b>

Source: Forsyth Barr analysis

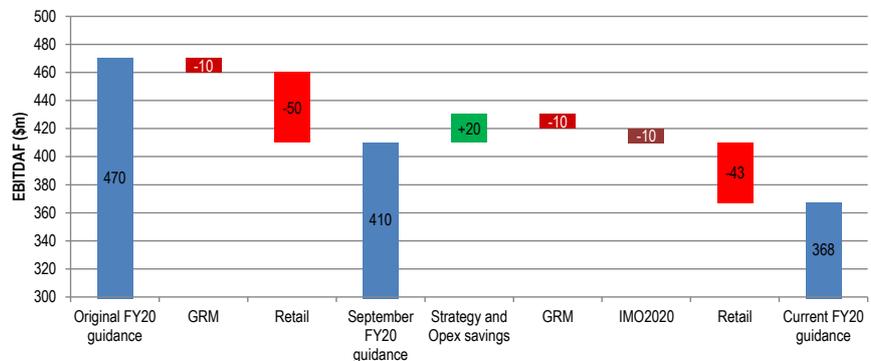
## Second big downgrade in three months

ZEL's earnings downgrade is the second material downgrade in three months with retail competition being the main factor on both occasions. The chart below shows the adjustments to FY20 EBITDAF and (broadly) the reasons for those changes. In essence there are two main issues:

- Increased retail competition impacting on margin and volume (~70% of the downgrade).
- International Maritime Organization (IMO) 2020 low-sulphur regulations having a greater negative impact than expected.

Of the two issues, the increased retail competition is of more concern, as it is likely to impact future earnings. We expect IMO2020 effects to be temporary.

Figure 4. ZEL FY20 EBITDAF guidance changes



Source: ZEL, Forsyth Barr analysis

### Two competitive dynamics hurting retail margins

The total retail impact on FY20 EBITDAF is estimated to be ~\$93m, with an additional \$43m in this recent downgrade.

#### Low-cost operators growing into new regions

Most of the industry service station growth has come from low-cost operators, such as Gull, Waitomo and NPD. In particular, Gull and Waitomo have started to expand into regions where they previously did not compete, such as Wellington and the South Island.

The typical market reaction has seen the big three players compete on price in locations where the low the cost operators are, with margins lifting elsewhere. Our analysis indicated ZEL would lose between -\$0.5m to -\$1.0m for each service station impacted by competition opening nearby, or between -\$3m to -\$9m per annum (refer *Gull Migrates South*, published 15 April 2019). Whilst there is no doubt low-cost operators are having an effect on the retail market, it is not the primary driver of ZEL's earnings issues.

#### Big three players start nationwide price competition

The main issue has been the change in pricing behaviour of Mobil, which changed in early July 2019. It is unclear why Mobil is pricing more aggressively and there are several theories including:

- Recent changes to the loyalty schemes means Mobil no longer has a relationship with a supermarket and does not access either of the large loyalty programmes (BP has AA Smartfuel and ZEL has Fly-buys & Airpoints), forcing it to launch its own loyalty programme. This is a plausible explanation, although the main loyalty scheme changes took place four months ago.
- Mobil was looking to take market share ahead of a possible sale (unlikely in our view) or replace recent supply volumes it has lost (Mobil no longer supplies Foodstuff or Gull).

- Mobil is looking to halt/slow the expansion of the low-cost retailers and make it very difficult for the new third-party Timaru fuel terminal.
- A Machiavellian explanation is that Caltex Australia via Gull has been trying to lower market retail margins in order to lower industry earnings and make a takeover easier to achieve. Mobil being the first party to fight back on price.
- Mobil was lowering margins whilst the Commerce Commission process was being finalised. In our view this is unlikely, as starting price competition in July is too little too late (whilst the ComCom noted the recent increase in retail price competition, it was quick to dismiss it as a reason not to recommend regulatory change).

Whatever the reason for Mobil changing its pricing strategy, the effects on industry profitability are obvious. In addition, whilst ZEL clearly expected Mobil's behaviour to be temporary, it has continued long-enough that it has been forced to downgrade.

#### Could the retail dynamics change?

Yes. The dramatic decline in sector earnings could reverse with a change in pricing strategy. In addition, as discussed above, we would be surprised if price competition got worse still — particularly on a permanent basis. That said, we're not assuming an improvement and further short-term deterioration cannot be ruled out.

### IMO2020 effects

#### Direct effects — dealing with excess product etc...

The main direct issue for ZEL is what to do with unwanted product. Typically Refining NZ (NZR) makes more high sulphur fuel oil than ZEL sells, forcing it to export the product at very low, to negative, margin. IMO2020 has exacerbated this issue as ZEL's customers' demand for high sulphur fuel oil has fallen. However, when ZEL uses NZR, it will make a certain amount of high sulphur fuel oil.

ZEL had tentatively put in place strategies with third parties to offset this particular issue. However, with IMO2020 having unexpected negative effects on the refining sector, the third party strategies may no longer be possible.

This direct IMO2020 effect on EBITDAF is expected to be ~-\$10m.

#### Indirect effects — Refining NZ gross refining margin (GMR) collapse

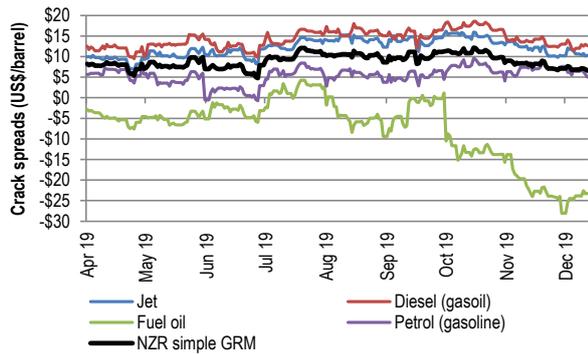
ZEL's first FY20 guidance downgrade in September included -\$10m for a lower than expected GRM (unrelated to IMO2020). There is an additional -\$10m in this downgrade related to a lower GRM caused by IMO2020 effects being unexpectedly negative.

ZEL has indicated that the GRM it is currently receiving from NZR is ~US\$2/barrel. That is below our estimate of the floor GRM of ~US\$3.1/barrel. However, there is no risk of ZEL making floor top-up payments to NZR in 2019 — the GRM has been well above the floor for all of 2019.

There is a risk of floor top-up payments being required at the beginning of 2020 (4Q20). ZEL has indicated that it expects the GRM to remain low in 4Q20. NZR, in a release to the market, has countered ZEL's view and maintains its view that gasoil crack spreads will increase, leading to an increase in the GRM. However, if floor top-up payments are required in 4Q20, it is almost certain those payments will be reversed in FY21 as the GRM needs to be below ~US\$3.10/barrel for the whole of 2021 — hence, it is a timing issue at worst.

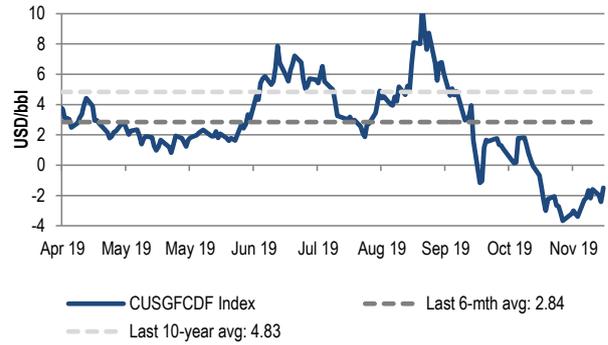
The following charts highlight the decline in gross refining margins, with the main issue being a decline in high sulphur fuel oil crack spreads. It was expected (and NZR still expects) that diesel (gasoil) crack spreads would increase as shippers switch to low sulphur alternatives. As yet, that has not happened.

Figure 5. Product crack spreads vs. Brent/Dubai crude mix



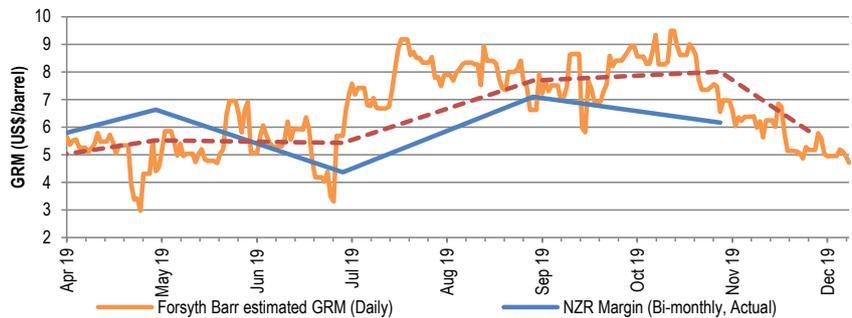
Source: Bloomberg, Forsyth Barr analysis

Figure 6. Bloomberg benchmark Singapore complex refining margin



Source: Bloomberg, Forsyth Barr analysis

Figure 7. Forsyth Barr estimated NZR GRM



Source: Bloomberg, Forsyth Barr analysis

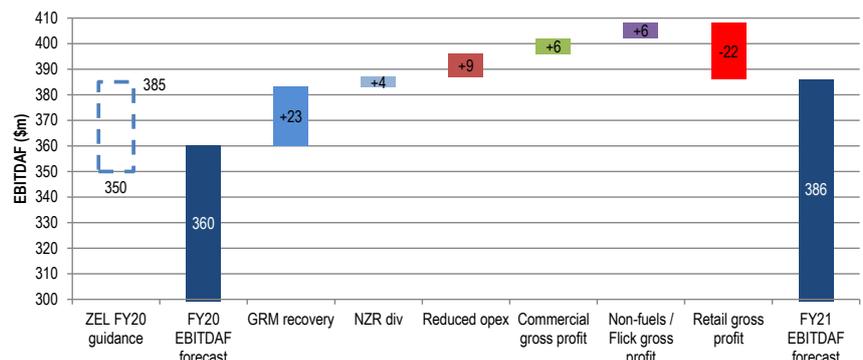
## Looking ahead to FY21 (and beyond)

We have cut our FY20 EBITDAF forecast -\$29m to \$360m, towards the bottom of ZEL's revised FY20 \$350m to \$385m guidance range. -\$14m is due to the very low NZR GRM ZEL is experiencing at present. The remainder is a further cut in retail margins. We have also cut our FY20 dividend forecast -8cps to 40cps, in line with ZEL's revised guidance.

Whilst there is still 3.5 months to go in FY20, focus is now moving ahead to FY21 and beyond. We have cut our FY21 EBITDAF forecast -\$34m (-8.1%) to \$386m, that is +\$26m up on our revised FY20 forecast.

The factors behind the increase in FY21 EBITDAF vs. FY20 are non-retail related. The biggest increase is due to the GRM normalising. The reduction in forecast opex comes from a fall in marketing costs as FY20 marketing spend was elevated around the loyalty scheme changes. We are forecasting FY21 retail gross profit to be -\$22m below FY20 as most of the retail pain started in 2Q20, with 1Q20 only slightly down on original guidance.

Figure 8. FY20 to FY21 EBITDAF bridge



Source: Forsyth Barr analysis

**Figure 9. Forecast changes**

	FY20	FY20	%	FY21	FY21	%	FY22	FY22	%
	Old	New	Chg	Old	New	Chg	Old	New	Chg
Revenue	5,166	5,152	0%	5,169	5,131	-1%	5,079	5,043	-1%
Gross profit	800	772	-4%	822	787	-4%	819	787	-4%
<b>Gross Margin</b>	<b>15.5%</b>	<b>15.0%</b>	<b>-3%</b>	<b>15.9%</b>	<b>15.3%</b>	<b>-3%</b>	<b>16.1%</b>	<b>15.6%</b>	<b>-3%</b>
Operating costs	(411)	(411)	0%	(402)	(402)	0%	(405)	(405)	0%
<b>EBITDAF</b>	<b>389</b>	<b>360</b>	<b>-7%</b>	<b>420</b>	<b>386</b>	<b>-8%</b>	<b>413</b>	<b>382</b>	<b>-8%</b>
Depreciation & amortisation	(147)	(147)	0%	(141)	(141)	0%	(137)	(137)	0%
<b>EBIT</b>	<b>242</b>	<b>214</b>	<b>-12%</b>	<b>279</b>	<b>245</b>	<b>-12%</b>	<b>276</b>	<b>245</b>	<b>-11%</b>
Net Interest	(64)	(64)	0%	(63)	(64)	1%	(59)	(60)	1%
Other	(38)	(38)	0%	-	-		-	-	
<b>Pre-tax profit</b>	<b>140</b>	<b>112</b>	<b>-20%</b>	<b>215</b>	<b>180</b>	<b>-16%</b>	<b>217</b>	<b>185</b>	<b>-15%</b>
Tax expense	(47)	(39)	-17%	(60)	(51)	-16%	(61)	(52)	-15%
<b>NPAT</b>	<b>93</b>	<b>72</b>	<b>-22%</b>	<b>155</b>	<b>130</b>	<b>-16%</b>	<b>156</b>	<b>133</b>	<b>-15%</b>
Minority interest	19	19	0%	9	9	3%	8	8	4%
<b>NPAT post-minorities</b>	<b>112</b>	<b>91</b>	<b>-18%</b>	<b>164</b>	<b>139</b>	<b>-15%</b>	<b>164</b>	<b>142</b>	<b>-14%</b>
<b>Normalised Profit</b>	<b>149</b>	<b>128</b>	<b>-14%</b>	<b>164</b>	<b>139</b>	<b>-15%</b>	<b>164</b>	<b>142</b>	<b>-14%</b>
Earnings per share (eps)	37.1	32.0	-14%	41.0	34.8	-15%	41.1	35.4	-14%
Dividend (cps)	48.0	40.0	-17%	48.0	41.5	-14%	48.0	43.0	-10%
<b>Key operating assumptions</b>									
Petrol	1,136	1,136	0%	1,139	1,139	0%	1,126	1,126	0%
Diesel - Retail	446	446	0%	438	438	0%	427	427	0%
Diesel - Commercial	799	799	0%	831	831	0%	846	846	0%
Diesel - Biofuels	6	6	0%	14	14	0%	22	22	0%
Jet	870	870	0%	897	897	0%	910	910	0%
Marine	154	154	0%	132	132	0%	133	133	0%
Bitumen & Other	131	131	0%	142	142	0%	143	143	0%
Domestic supply	551	551	0%	566	566	0%	574	574	0%
<b>ZEL specific volumes (m litres)</b>	<b>4,094</b>	<b>4,094</b>	<b>0%</b>	<b>4,159</b>	<b>4,159</b>	<b>0%</b>	<b>4,180</b>	<b>4,180</b>	<b>0%</b>
Industry and export supply	82	82	0%	102	102	0%	100	100	0%
<b>Total fuel volumes (m litres)</b>	<b>4,176</b>	<b>4,176</b>	<b>0%</b>	<b>4,260</b>	<b>4,260</b>	<b>0%</b>	<b>4,280</b>	<b>4,280</b>	<b>0%</b>
GM excl supply (cpl)	16.0	15.6	-2%	15.8	15.0	-5%	15.6	14.9	-5%
GM incl refining (cpl)	17.5	16.9	-4%	17.5	16.8	-4%	17.3	16.5	-4%
<b>Gross profit make-up</b>									
Fuels gross profit	654	641	-2%	658	624	-5%	653	622	-5%
Refining gross profit	63	49	-23%	72	72	0%	69	69	0%
Non-fuel gross profit	76	76	0%	80	80	0%	82	82	0%
NZR dividend	2	2	0%	6	6	0%	6	6	0%
Flick gross profit	4	4	0%	7	6	-9%	9	8	-8%
	<b>800</b>	<b>772</b>	<b>-4%</b>	<b>822</b>	<b>787</b>	<b>-4%</b>	<b>819</b>	<b>787</b>	<b>-4%</b>

Source: Forsyth Barr analysis

## Investment summary

Our rating is **OUTPERFORM**. Z Energy (ZEL) is offering investors good value, with the market pricing in additional downside that we do not believe is likely to eventuate. ZEL has yet to pull the cost lever and we expect it is looking attractive as a takeover target.

### 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.

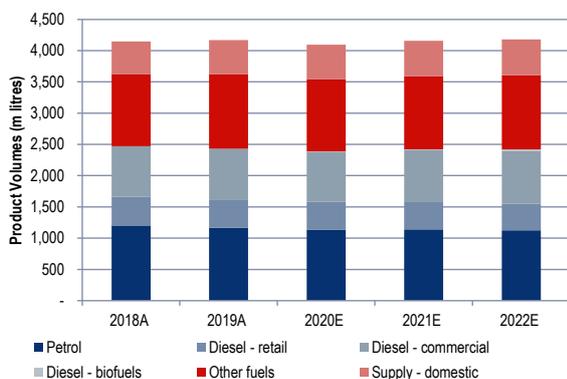
### Key risks

- **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.
- **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.

### Company description

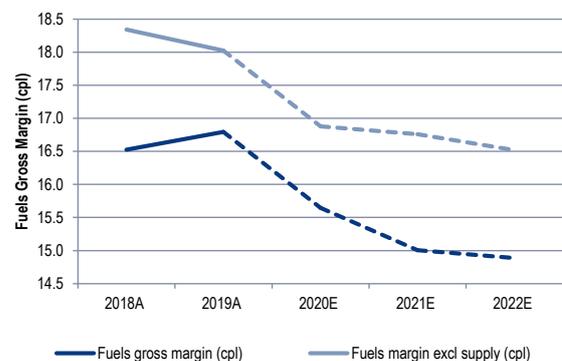
Z Energy is a downstream oil company. Its products include petrol, diesel, marine fuel oil and aviation fuel. Z retails petrol and diesel through a network of ~200 Z branded service stations and ~140 Caltex branded service stations. It sells fuel to the commercial market, which includes a network of 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 10. Fuel volumes



Source: Forsyth Barr analysis

Figure 11. Fuel gross margin



Source: Forsyth Barr analysis

Figure 12. 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

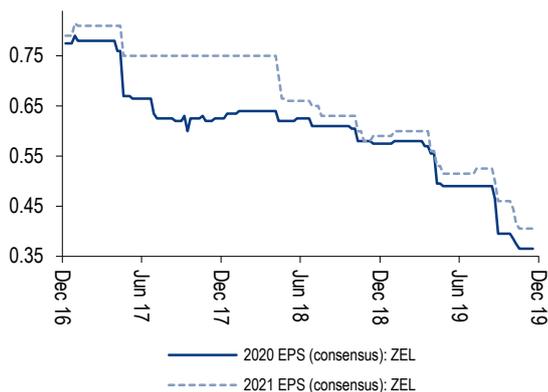
Figure 13. International Compcos

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>										
<b>Z Energy</b>	<b>ZEL NZ</b>	<b>NZ\$4.23</b>	<b>NZ\$1,692</b>	<b>13.2x</b>	<b>12.2x</b>	<b>7.0x</b>	<b>6.5x</b>	<b>11.8x</b>	<b>10.3x</b>	<b>9.8%</b>
Suburban Propane Partners LP	SPH US	US\$21.96	US\$1,363	17.5x	15.1x	9.3x	9.0x	17.0x	n/a	11.1%
World Fuel Services Corp	INT US	US\$43.04	US\$2,814	17.0x	14.4x	8.2x	7.7x	10.5x	9.9x	n/a
Contact Energy *	CEN NZ	NZ\$7.19	NZ\$5,161	19.6x	19.4x	12.5x	12.4x	21.4x	21.1x	5.5%
Mercury *	MCY NZ	NZ\$4.85	NZ\$6,607	26.8x	24.5x	15.0x	14.7x	24.7x	24.0x	3.3%
Trustpower *	TPW NZ	NZ\$7.18	NZ\$2,247	23.5x	22.0x	13.8x	13.4x	17.1x	16.6x	4.7%
Meridian Energy *	MEL NZ	NZ\$4.94	NZ\$12,661	25.4x	27.4x	16.6x	17.7x	25.7x	28.7x	4.4%
Genesis Energy *	GNE NZ	NZ\$3.00	NZ\$3,083	19.6x	16.6x	11.7x	10.7x	27.1x	23.2x	5.9%
Caltex Australia	CTX AT	A\$34.01	A\$8,493	23.0x	16.4x	10.3x	8.7x	16.6x	13.0x	3.6%
Viva Energy Group	VEA AT	A\$1.97	A\$3,831	n/a	16.5x	9.7x	8.2x	17.4x	13.7x	4.3%
<b>Compcio Average:</b>				<b>21.5x</b>	<b>19.1x</b>	<b>11.9x</b>	<b>11.4x</b>	<b>19.7x</b>	<b>18.8x</b>	<b>5.3%</b>
<b>ZEL Relative:</b>				<b>-39%</b>	<b>-36%</b>	<b>-41%</b>	<b>-43%</b>	<b>-40%</b>	<b>-45%</b>	<b>+83%</b>

EV = Current Market Cap + Actual Net Debt

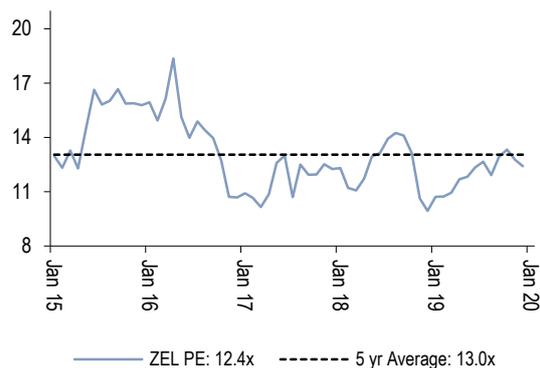
Source: \*Forsyth Barr analysis, Bloomberg Consensus, Compcio metrics re-weighted to reflect headline (ZEL) companies fiscal year end

Figure 14. Consensus EPS Momentum



Source: Forsyth Barr analysis, Bloomberg

Figure 15. 12 Month Forward PE



Source: Forsyth Barr analysis

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