

Z Energy

Flock of Black Swans Take Out Jet

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OUTPERFORM

Z Energy (ZEL) has faced many unexpected challenges in the past 18 months but none more so than the current COVID-19 black swan event. Jet fuel demand is plummeting, creating significant logistical issues and the imminent four week lock-down will also hit retail and commercial volumes, by an unknown amount. Our analysis of ZEL's earnings outlook and balance sheet strength suggests it will likely withstand the current environment. However, we expect the 2H20 final dividend and 1H21 interim dividend to be casualties of the need to preserve cash. That said, we believe the share price reaction has been overdone and whilst we are cutting our target price -11% to \$4.00, ZEL is a strong business that will come through the current crisis. We are retaining our OUTPERFORM rating.

NZX Code	ZEL	Financials: Mar/	19A	20E	21E	22E	Valuation (x)	19A	20E	21E	22E
Share price	NZ\$2.98	NPAT* (NZ\$m)	195.8	136.4	57.3	123.4	EV/EBITDA	4.4	5.5	8.0	6.1
Target price	NZ\$4.00	EPS* (NZc)	49.0	34.1	14.3	30.9	EV/EBIT	6.1	9.1	17.1	10.1
Risk rating	Medium	EPS growth* (%)	-7.4	-30.4	-58.0	n/a	PE	6.1	8.7	20.8	9.7
Issued shares	400.0m	DPS (NZc)	43.0	16.5	20.0	30.0	Price / NTA	4.7	28.7	8.4	6.4
Market cap	NZ\$1,192m	Imputation (%)	100	100	100	100	Cash div yld (%)	14.4	5.5	6.7	10.1
Avg daily turnover	858.2k (NZ\$4,727k)	*Based on normalised profits					Gross div yld (%)	20.0	7.7	9.3	14.0

Heading into uncharted territory

New Zealand's lock-down starts tonight. No one knows exactly how long the lock down will last (initially it's four weeks) or how that will impact fuel volumes and therefore earnings. Jet volumes are already being impacted and with Air New Zealand (AIR) cutting international services -85% and 80% of jet fuel consumption related to overseas travel, jet fuel demand is likely to be minimal. The impact on petrol and diesel volumes is less certain, hence, we have focussed on sensitivity analysis.

Debt covenants only threatened in a downside scenario

Its retail bond covenant is only breached if ZEL's core net debt/EBITDA ratio is above 3.5x for two consecutive periods (we do not know the bank or USPP covenants, but assume they are the same). We estimate that petrol and diesel volumes will need to fall more than -30% for the whole of 1H21, such that 1H20 EBITDA is less than \$80m (post-IFRS 16) before the covenant is threatened for the first time at 30 September 2021. However, we note that in addition to volume, retail margins will be a critical factor in 1H21 earnings.

Forecast changes reflect challenging near-term outlook

One casualty of the uncertain climate is likely to be the final 2H20 dividend. We struggle to see a scenario where a final dividend will be paid and also expect the 1H21 interim dividend will be similarly suspended to maximise cash retained in the business. Longer-term we have lowered our dividend forecast to 30cps as we expect ZEL to retain more cash in the business than it has previously. Our base 1H21 petrol and diesel volume decline assumption is -20%, with a recovery in 2H21. The impact on FY21 EBITDA is -24% (-\$84m) to \$266m. At this stage we anticipate a strong recovery in FY22, albeit not back to "normal" levels. Our FY22 EBITDA cut is -4% (\$14m) to \$348m.

We are retaining our OUTPERFORM rating. ZEL provides a product that is a core staple and so will have a degree of resilience to the forthcoming economic downturn. We believe the share price reaction is overdone with the valuation impact of the short-term earnings hit ~-10%. Our target price is -46cps (-11%) lower to \$4.00.

Z Energy (ZEL)

Priced as at 24 Mar 2020 (NZ\$)

2.98
12-month target price (NZ\$)*
4.00

Expected share price return	34.2%
Net dividend yield	6.7%
Estimated 12-month return	40.9%

Spot valuations (NZ\$)

1. DCF	3.85
2. Dividend Yield	3.79
3. Market Multiple	3.83

Key WACC assumptions

Risk free rate	2.00%
Equity beta	0.84
WACC	7.2%
Terminal growth	-2.0%

DCF valuation summary (NZ\$m)

Total firm value	2,813
(Net debt)/cash	(972)
Less: Capitalised operating leases	(299)
Value of equity	1,542

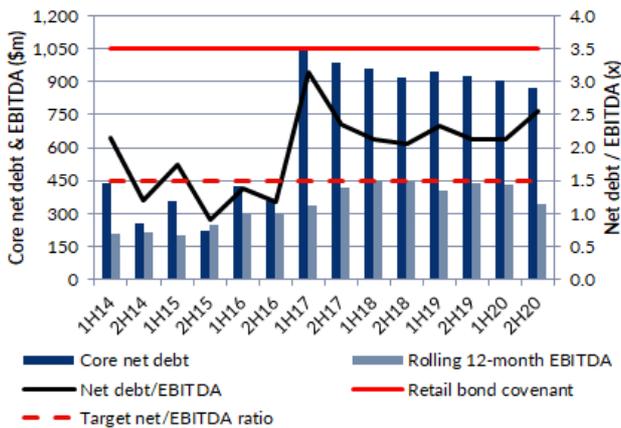
Profit and Loss Account (NZ\$m)	2018A	2019A	2020E	2021E	2022E	Valuation Ratios	2018A	2019A	2020E	2021E	2022E
Sales revenue	4,570.0	5,450.0	4,931.5	3,125.8	4,273.2	EV/EBITDA (x)	4.5	4.4	5.5	8.0	6.1
Normalised EBITDA	448.0	435.0	371.7	265.8	348.2	EV/EBIT (x)	5.8	6.1	9.1	17.1	10.1
Depreciation and amortisation	(102.0)	(122.0)	(146.6)	(141.3)	(137.0)	PE (x)	5.6	6.1	8.7	20.8	9.7
Normalised EBIT	347.0	312.0	224.2	124.4	211.2	Price/NTA (x)	11.1	4.7	28.7	8.4	6.4
Net interest	(52.0)	(51.0)	(63.7)	(57.6)	(51.3)	Free cash flow yield (%)	25.5	23.7	0.8	19.3	10.4
Associate income	1.0	(1.0)	(1.0)	0	0	Net dividend yield (%)	10.8	14.4	5.5	6.7	10.1
Tax	(82.0)	(61.0)	(42.7)	(18.7)	(44.8)	Gross dividend yield (%)	15.1	20.0	7.7	9.3	14.0
Minority interests	0	(2.0)	(18.6)	(9.2)	(8.3)	Capital Structure	2018A	2019A	2020E	2021E	2022E
Normalised NPAT	211.5	195.8	136.4	57.3	123.4	Interest cover EBIT (x)	6.7	6.1	3.5	2.2	4.1
Abnormals/other	(6.5)	(15.8)	(35.0)	0	0	Interest cover EBITDA (x)	8.6	8.5	5.8	4.6	6.8
Reported NPAT	205.0	180.0	101.4	57.3	123.4	Net debt/ND+E (%)	57.2	55.4	63.9	56.1	56.3
Normalised EPS (cps)	52.9	49.0	34.1	14.3	30.9	Net debt/EBITDA (x)	1.8	1.9	2.8	3.1	2.4
DPS (cps)	32.3	43.0	16.5	20.0	30.0	Key Ratios	2018A	2019A	2020E	2021E	2022E
Growth Rates	2018A	2019A	2020E	2021E	2022E	Return on assets (%)	12.4	11.0	7.4	4.3	7.0
Revenue (%)	18.3	19.3	-9.5	-36.6	36.7	Return on equity (%)	24.7	21.3	16.5	6.6	14.2
EBITDA (%)	6.9	-2.9	-14.5	-28.5	31.0	Return on funds employed (%)	17.4	15.8	10.0	6.1	10.2
EBIT (%)	3.3	-10.1	-28.1	-44.5	69.7	EBITDA margin (%)	9.8	8.0	7.5	8.5	8.1
Normalised NPAT (%)	8.2	-7.4	-30.4	-58.0	>100	EBIT margin (%)	7.6	5.7	4.5	4.0	4.9
Normalised EPS (%)	8.2	-7.4	-30.4	-58.0	>100	Capex to sales (%)	1.9	1.0	1.8	1.4	1.1
Ordinary DPS (%)	10.2	33.1	-61.6	21.2	50.0	Capex to depreciation (%)	140	85	107	56	56
Cash Flow (NZ\$m)	2018A	2019A	2020E	2021E	2022E	Imputation (%)	100	100	100	100	100
EBITDA	448.0	435.0	371.7	265.8	348.2	Pay-out ratio (%)	61	88	48	140	97
Working capital change	61.0	(159.0)	53.2	95.7	(70.3)	Operating Performance	2018A	2019A	2020E	2021E	2022E
Interest & tax paid	(103.0)	(161.0)	(135.9)	(82.4)	(104.0)	Product volumes (m litres)					
Other	(15.0)	223.0	(192.0)	(4.0)	(4.0)	Petrol	1,204	1,165	1,100	935	1,073
Operating cash flow	391.0	338.0	97.1	275.0	169.9	Diesel - retail	461	454	439	373	428
Capital expenditure	(87.0)	(55.0)	(87.7)	(45.0)	(45.4)	Diesel - commercial	807	812	791	685	791
(Acquisitions)/divestments	18.0	(28.0)	36.0	0	0	Other fuels	1,153	1,193	1,137	649	1,043
Other	12.0	4.0	(27.0)	(28.0)	(26.1)	Supply - domestic	520	544	543	464	531
Funding available/(required)	334.0	259.0	18.4	202.0	98.4	Sub-total	4,145	4,168	4,011	3,106	3,865
Dividends paid	(134.0)	(152.0)	(198.0)	0	(120.0)	Supply - industry & export	178	280	84	55	95
Equity raised/(returned)	(2.0)	(1.0)	0	0	0	Total Fuels	4,323	4,448	4,095	3,162	3,960
(Increase)/decrease in net debt	198.0	106.0	(179.6)	202.0	(21.6)	Retail service stations	343	343	338	331	330
Balance Sheet (NZ\$m)	2018A	2019A	2020E	2021E	2022E	Petrol/service station (m litres)	3.72	3.60	3.42	2.91	3.35
Working capital	196.0	358.0	325.8	230.1	300.4	Diesel/service station (m litres)	1.34	1.32	1.29	1.12	1.30
Fixed assets	870.0	830.0	805.8	779.7	754.5	Gross profit (NZDm)					
Intangibles	750.0	668.0	785.3	733.0	684.6	Fuels	685	700	650	544	602
Right of use asset	0	0	286.0	286.0	286.0	Refining	77	54	48	21	59
Other assets	134.0	161.0	219.0	219.0	219.0	Non-fuels	76	81	77	60	72
Total funds employed	1,950.0	2,017.0	2,421.9	2,247.8	2,244.5	Flick Electric	0	1	4	6	8
Net debt/(cash)	824.0	827.0	1,045.6	829.6	839.1	Gross profit	838	836	779	632	741
Lease liability	0	0	299.0	299.0	299.0	Fuels gross margin (cpl)	16.5	16.6	16.2	17.5	15.6
Other liabilities	269.0	270.0	250.5	244.3	236.4	Fuels margin incl refining (cpl)	17.6	17.0	17.0	17.9	16.7
Shareholder's funds	857.0	902.0	827.4	884.7	888.2	Fuels margin excl supply (cpl)	18.3	18.0	17.5	18.2	17.1
Minority interests	0	18.0	(0.6)	(9.8)	(18.1)	Non-fuels revenue/station (NZD 000)	373	398	379	297	360
Total funding sources	1,950.0	2,017.0	2,421.9	2,247.8	2,244.5						

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

Black swans place focus on the balance sheet

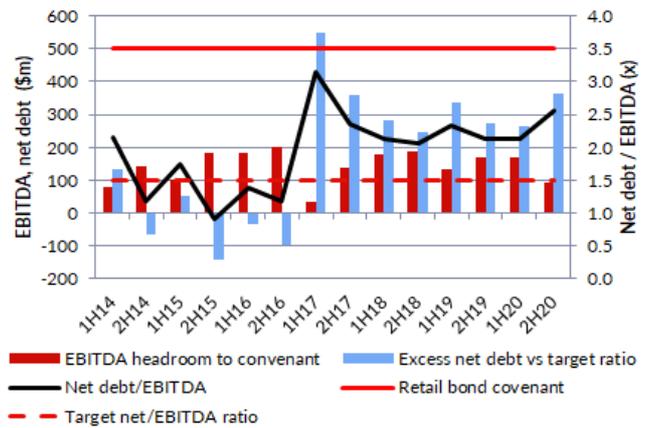
In an unprecedented event, a flock of black swans has hit the global economy in the form of COVID-19. In this note we take a closer look at ZEL's balance sheet and its ability to withstand material drops in volume over the next month. ZEL has a relatively high debt level, certainly above what the Board is targeting with weak earnings over the past 24 months hampering ZEL's ability to repay debt as fast as it would like post-the Caltex take-over. ZEL's post-Caltex take-over target core net debt/EBITDA ratio was ~1.5x (EBITDA on a pre-IFRS 16 basis), or ~\$600m-\$700m. At 30 September 2019, core net debt was \$906m, ~+\$300m higher than desired. We estimate core debt at 31 March 2020 will be ~\$870m following a strong earnings period in 2H20.

Figure 1. ZEL net debt and EBITDA



Source: ZEL, Forsyth Barr analysis

Figure 2. EBITDA and net debt headroom



Source: ZEL, Forsyth Barr analysis

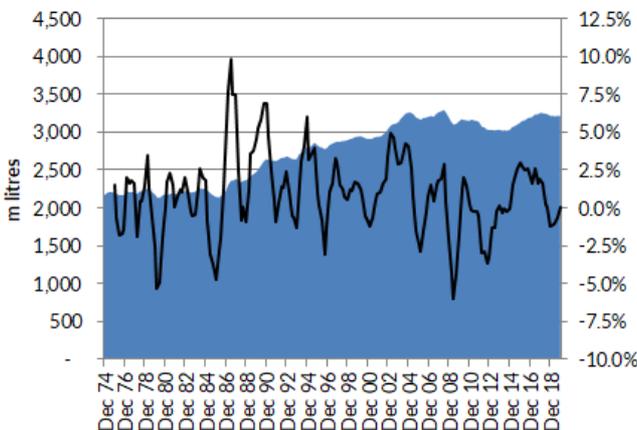
Understanding New Zealand's fuel supply/demand picture – implications of falling demand

There is limited data on the actual demand destruction taking place at this point. We don't know how long the lock-down will last, we don't know what that will do to fuel demand and we don't know how long it will take for demand to recover once restrictions ease. However, it is clear that jet fuel demand in particular is collapsing. Diesel and petrol volumes will also drop rapidly as a large percentage of the population is required to stay at home.

New Zealand (and ZEL) is entering uncharted waters in terms of the demand shock being experienced. On a rolling 12-month basis the biggest key product volume drop never topped -10%, even going back to the 1970s oil price shocks (when carless days were introduced for a period) and the GFC. The biggest quarterly drops in the last 35 years were:

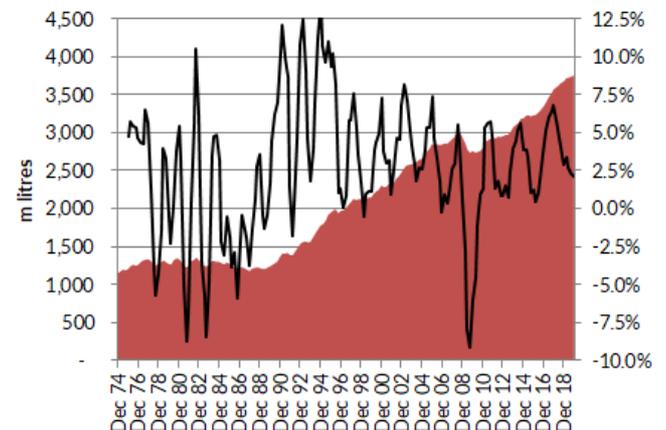
- Petrol -7% in March 2009
- Diesel -13% in March 1986
- Jet -18% in March 1997 (domestic and international demand fell about the same)

Figure 3. Petrol demand growth rate



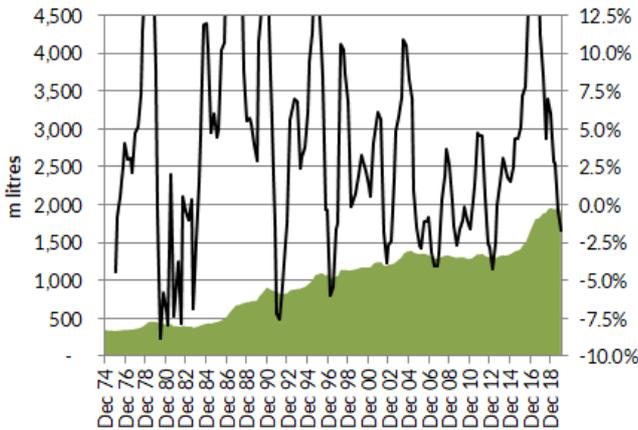
Source: MBIE, Forsyth Barr analysis

Figure 4. Diesel demand growth rate



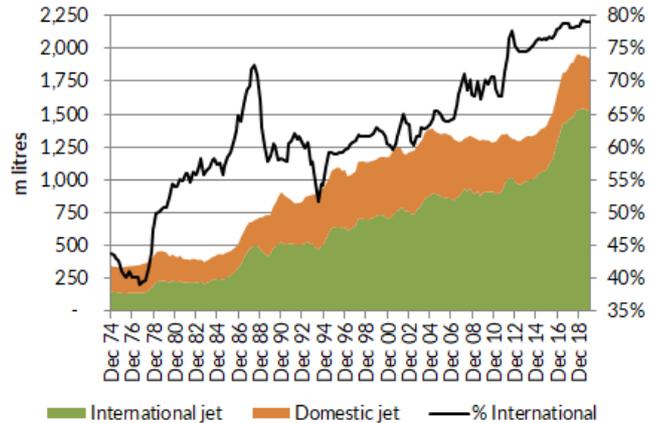
Source: MBIE, Forsyth Barr analysis

Figure 5. Jet fuel demand growth



Source: MBIE, Forsyth Barr analysis

Figure 6. International vs. domestic jet fuel demand



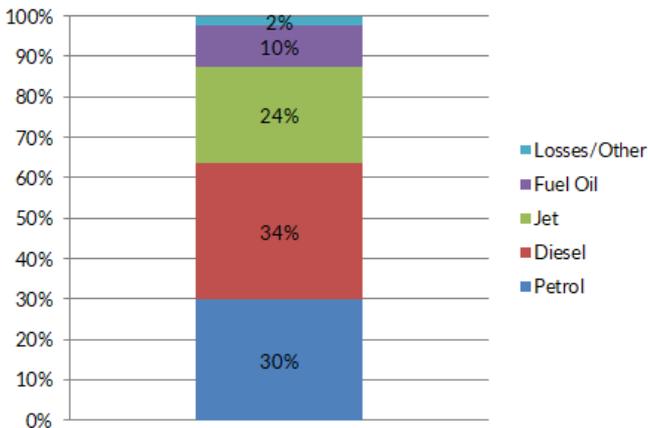
Source: MBIE, Forsyth Barr analysis

The key issue in the near-term for ZEL is jet fuel as that is the product that is experiencing the greatest drop in demand. Air New Zealand (AIR) has so far cut all international travel ~-85% and domestic services -30%, with further cuts likely. The problem for ZEL is that a barrel of oil makes a relatively fixed amount of jet fuel, hence, using the refinery as normal will result in too much jet being made vs. jet demand.

Depending on the specific crude oil used and the refinery configuration, a barrel of oil (159 litres) produces a variety of products in reasonably specific volumes. In New Zealand, the refinery produces, roughly:

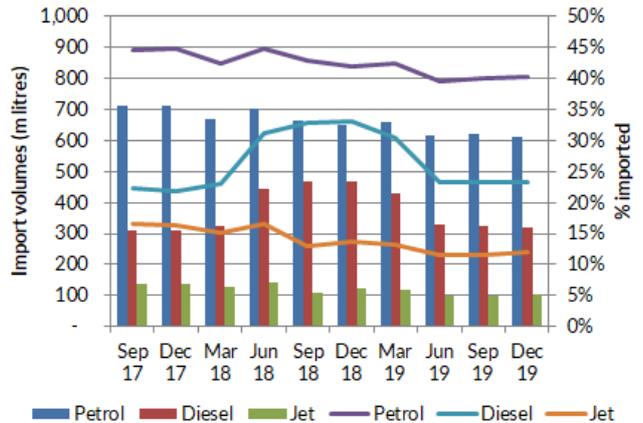
- 30% petrol
- 34% diesel
- 24% jet fuel
- 10% fuel oil
- 2% other/losses

Figure 7. Products produced at the refinery



Source: MBIE, Forsyth Barr analysis

Figure 8. Import volumes vs. underlying demand



Source: MBIE, Forsyth Barr analysis

That said, ZEL does have some options to reduce the impacts:

1. Make more diesel and less jet (diesel and jet are both middle distillate products and can, therefore, be substituted to some degree)
2. Reduce the volumes made at the refinery (potentially even stopping use)

Changing the refinery’s production mix

The ability to change the refinery mix is limited, although the most similar products are jet and diesel, with the ability to switch 3% to 4% between the two products. However, while making more diesel is helpful, that will not be enough to avoid having to export surplus jet.

Temporarily reducing the use of the refinery

To avoid too much surplus jet, ZEL could reduce its use of the refinery, or temporarily stop completely. This is something it has never done.

The advantage to ZEL of not using the refinery is twofold. First, ZEL is able to import its specific requirements and so there is limited risk of creating an oversupply situation. Second, the supply chain from buying crude is ~90 days vs. importing product of ~30 days. Given the uncertainty in the demand environment, having a shorter supply chain is advantageous.

The downside from not using the refinery is the fee floor, which is payable regardless of whether ZEL uses the refinery or not. The fee floor is a fixed NZ\$140m (which converted to ~US\$3.10/barrel in the January/February period). ZEL's share of the floor is ~\$60m (per annum).

The key question for ZEL is, whether it is cheaper to import its needs and not use the refinery or to produce surplus fuel (jet being the main issue) and sell that at a loss in a depressed market? We estimate that if ZEL was forced to sell surplus product at a -5cpl loss, it would be better importing and paying the refinery penalty.

Our base assumption is that ZEL temporarily stops using the refinery. The other refinery users (BP & Mobil) will be in the same position and have their own refineries that can supply product. However, we believe there is a win-win solution for the refinery and fuel retailers. If the refinery temporarily closed, earnings would increase due to a fall in operating costs that it would otherwise incur. We can see a possible deal being done between the fuel companies and the refinery where the refinery does not come back from its maintenance shut down (scheduled for the end of May) and the fee floor payment is temporarily reduced for the fuel companies. The refinery will continue to be used in the interim as crude oil will have already been purchased to be refined in April.

Scenario and sensitivity analysis – how robust is the balance sheet?

We don't know many things:

- How long the lock-down will take place?
- The impact on demand?
- How quickly demand will recover once the crisis is over?
- The impact on retail margins?
- What costs ZEL is able to take out of the business in the short-term to preserve cash?

The key question is what earnings level (and therefore what volume reduction) is likely to result in debt covenants coming under pressure.

This is a difficult question to answer, given the various moving parts. In undertaking our analysis we have focussed on petrol and diesel demand falls, because that is less certain than jet given the announcements AIR and other airlines have made.

Our core assumptions are as follows:

1. It will take 18 months for volumes to return to normal. We assume the demand reduction in 2H21 will be half the demand reduction in 1H21, with normal volumes from 2H22 onwards (refer Fig. 9 for sensitivity analysis used).
2. We assume a -75% reduction in jet volumes. In 2019 jet fuel for international travel accounted for 79% of jet fuel consumption, hence, jet demand will be down materially.
3. No use of the refinery in 1H21, with ZEL paying \$20m to NZR over that period (a -33% reduction in the fee floor payment).
4. Retail margins firm +1cpl to partially compensate for the volume fall. However, we expect competition to force retail margins lower again as volumes recover. What happens to retail margins will have a big impact on profitability.
5. Non-fuel income falls 1.5x the drop in petrol/diesel volumes. ZEL provides an essential service, hence, the service stations will remain open, but the stores are in essence closed with sales only taking place through the cashier window.
6. There are no additional opex savings other than the 20% variable operating costs we model. (Note: this excludes the fuel itself which is a 100% variable cost).
7. We assume no final FY20 dividend and no FY21 dividend. Given the uncertainties ahead, in our view it is very unlikely ZEL will pay a final dividend in FY20. A very quick recovery in volumes (which requires a bounce back in the economy) may see an FY21 dividend paid.

Note: all of the analysis is undertaken on a pre-IFRS 16 basis as that is how the debt covenants are calculated.

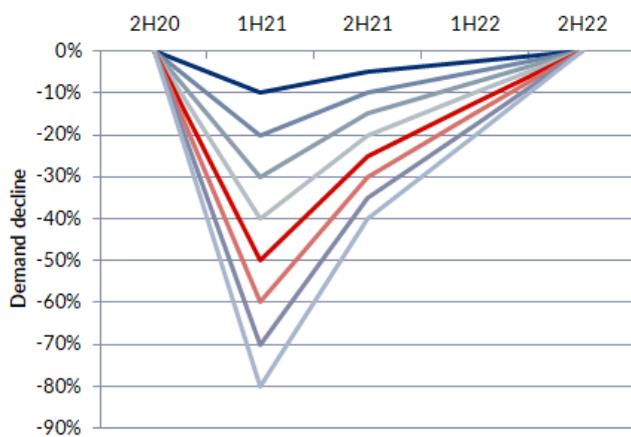
Key take-outs from our analysis:

- 1H21 EBITDA of ~\$80m (or less) is required to breach the 3.5x net debt/EBITDA ratio at 30 September 2020. That equates to a ~-30% fall in diesel and petrol volumes.
- FY21 EBITDA of ~\$250m (or less) will result in a covenant breach at 31 March 2021. That equates to a ~-23% fall in petrol and diesel volumes in 1H21 recovering to an -11% fall in 2H21 vs. pcp.
- Whilst ZEL may avoid a covenant breach in 1H21, it is still likely to need a reasonable economic recovery in 2H22.

It is not a foregone conclusion that ZEL will breach its debt covenants, however, there are plausible scenarios where it could. Overseas data points have been hard to come by, but indications are Italian fuel volumes were down -30% in the first two weeks of its shut-down. However, a key question will be where retail margins go and the ability of ZEL to cut operating costs.

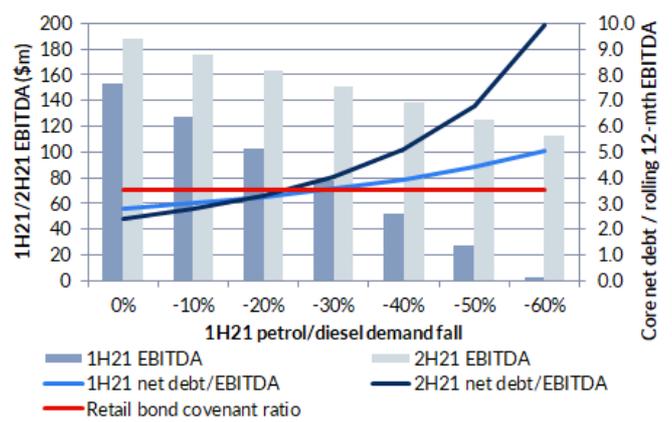
The big issue for ZEL is not the level of debt, but the short-term hit to earnings.

Figure 9. Modelled demand profile for sensitivity analysis



Source: Forsyth Barr analysis

Figure 10. EBITDA and debt under demand fall scenarios



Source: Forsyth Barr analysis

Figure 11. EBITDA and debt under demand decline scenarios

1H21 petrol, diesel demand fall	Petrol, diesel, +supply m litres	1H21		Petrol, diesel, +supply m litres	2H21		Petrol, diesel, +supply m litres	1H22	
		Post IFRS16 EBITDA \$m	Rolling 12 mth net debt / EBITDA x		Post IFRS16 EBITDA \$m	Rolling 12 mth net debt / EBITDA x		Post IFRS16 EBITDA \$m	Rolling 12 mth net debt / EBITDA x
0%	1,400	153	2.8	1,466	188	2.4	1,400	169	2.3
-10%	1,260	128	3.0	1,393	176	2.8	1,365	164	2.5
-20%	1,120	103	3.3	1,319	163	3.3	1,330	157	2.7
-30%	980	77	3.6	1,246	151	4.0	1,295	150	3.0
-40%	840	52	3.9	1,173	138	5.1	1,260	141	3.4
-50%	700	27	4.4	1,099	125	6.8	1,225	131	3.9
-60%	560	2	5.1	1,026	113	10.0	1,190	117	4.5

Source: Forsyth Barr analysis

Implications of a covenant breach

ZEL has three debt providers, the banks, retail bonds totalling \$480m and USPP totalling NZ\$378m. The publicly notified retail bond covenant is 3.5x core debt to EBITDA (i.e. excluding the working capital facility). A breach occurs only after the net debt to EBITDA ratio exceeds 3.5x *on two consecutive periods*. For ZEL, that means 30 September 2020 and 31 March 2021. The key date is 30 September 2020, as maintaining net debt/EBITDA less than 3.5x at that date is likely to avoid a covenant breach at 31 March 2021.

The bank covenant is 3.0x net debt/EBITDA. However, we expect that the banks will be accommodating under the current circumstances, hence, the key covenant is the retail bond 3.5x covenant. ZEL has not disclosed the USPP covenant, although we assume it is the same/similar to the bond covenant.

Figure 12. ZEL core debt as at 30 September 2019 (excludes drawn working capital of \$134m)

	\$m	Comment
Bank	48	Facility is \$180m
Bonds	480	A \$135m bond was due on November 2019, which ZEL repaid with its bank facility. The next bond is not due until November 2021
USPP	378	US\$270m taken out in 2017 over three tranches, first tranche due in 2026
	906	

Source: ZEL, Forsyth Barr analysis

We expect that if there is a covenant breach, the banks and bond Supervisor (Trustees Executor) will likely be involved in discussions, and are most likely to act together. Given the main issue facing ZEL is a short-term dip in earnings, we expect the banks will be accommodating of a short-term breach in covenants. Prima facie, the bonds would require repaying, however, we believe there is a good chance the bond Supervisor will fall in line with the banks. The USPP participants are harder to read. We have seen examples of both tough and relatively benign responses to covenant breaches.

What will the Board do?

Given the circumstances, and the uncertainty, we expect the Board will wait two to three months to see how the situation evolves. If the lock-down only lasts a month and volumes recover to ~-10% below normal within three months, ZEL should be able to avoid an initial covenant breach at 30 September 2020. After a couple of months, the Board will have a clearer idea of ZEL's financial position.

Nevertheless, after this event, we believe the Board will take a more conservative approach to the dividend and look to preserve more cash in the business. We, therefore, assume a reduction in the dividend to 30cps, starting with a 2H21 dividend of 20cps.

Fundamentally, ZEL is a strong business that has been caught out by extraordinary circumstances. We can see some positives coming out the other side of COVID-19 with an extreme focus on costs and industry structures aiding long-term profitability.

Working capital facility may also need short-term increase

Oil prices have plummeted to their lowest level in 17 years (the last time Brent went below US\$25/barrel was 2003). Ordinarily, the absolute level of oil prices does not have a material impact on ZEL's fuel margins (although ZEL prefers lower crude prices as it stimulates demand and takes political pressure off). However, the rate of change does have an impact on margins, and also working capital.

ZEL is currently selling fuel that it procured at prices materially higher than the spot price. We estimate that ZEL requires additional short-term working capital of between \$150m and \$200m. However, that should reverse relatively quickly as lower fuel volumes sold will result in no additional purchases for a period of time as stock levels will be materially higher than demand.

Forecast changes and investment view

The forecastability of ZEL's earnings is difficult at the best of times and currently is a nearly impossible task. Therefore, these forecast changes should be taken with a significant health warning – we expect they will need to be changed as we learn more.

That said, the key changes we are making at this juncture are:

- Assumed a -20% reduction in 1H21 petrol and diesel volumes and a -75% reduction in jet volumes, with a recovery in 2H21. A -20% hit to volumes roughly equates to -50% demand hit in April, -30% in May and -10% for the remainder of 1H21 (all other things being equal).
- No refining gross margin in 1H21 as its use is temporarily paused, but ZEL pays \$20m as its contribution to the fee floor.

- No final FY20 dividend or interim FY21 dividend to enable ZEL to reduce debt levels quickly. When dividends resume at the end of FY21, we assume it will be at 30cps (vs. current FY20 guidance of 40cps), 10cps as an interim dividend and 20cps as a final dividend. This will enable debt to be repaid faster over the next few years.

We assume a capital raise will not be necessary.

Figure 13. Forecast changes

\$m	FY20	FY20	% Chg	FY21	FY21	% Chg	FY22	FY22	% Chg
	Old	New		Old	New		Old	New	
Revenue	4,978	4,966	0%	3,915	3,160	-19%	4,500	4,328	-4%
Gross profit	785	780	-1%	746	632	-15%	762	743	-3%
Gross Margin	15.8%	15.7%	-1%	19.1%	20.0%	5%	16.9%	17.2%	1%
Operating costs	(409)	(408)	0%	(397)	(366)	-8%	(400)	(394)	-1%
EBITDAF	376	372	-1%	350	266	-24%	362	348	-4%
Depreciation & amortisation	(147)	(147)	0%	(141)	(141)	0%	(137)	(137)	0%
EBIT	230	225	-2%	208	124	-40%	225	211	-6%
Net Interest	(64)	(64)	0%	(60)	(58)	-4%	(57)	(51)	-10%
Other	(38)	(38)	0%	-	-	-	-	-	-
Pre-tax profit	128	123	-3%	148	67	-55%	168	160	-5%
Tax expense	(44)	(43)	-3%	(41)	(19)	-55%	(47)	(45)	-5%
NPAT	84	81	-4%	107	48	-55%	121	115	-5%
Minority interest	19	19	0%	9	9	0%	8	8	0%
NPAT post-minorities	103	99	-3%	116	57	-51%	129	123	-5%
Normalised Profit	140	136	-2%	116	57	-51%	129	123	-5%
Earnings per share (eps)	34.9	34.1	-2%	29.0	14.3	-51%	32.4	30.8	-5%
Dividend (cps)	40.0	16.5	-59%	38.0	20.0	-47%	38.0	30.0	-21%
Key operating assumptions									
Petrol	1,119	1,100	-2%	1,124	935	-17%	1,097	1,073	-2%
Diesel - Retail	446	439	-1%	444	373	-16%	428	428	0%
Diesel - Commercial	790	791	0%	816	685	-16%	839	791	-6%
Jet	842	843	0%	768	375	-51%	845	767	-9%
Marine	154	154	0%	132	132	0%	133	133	0%
Bitumen & Other	139	139	0%	142	142	0%	143	143	0%
Domestic supply	545	543	0%	555	464	-16%	563	531	-6%
ZEL specific volumes (m litres)	4,036	4,011	-1%	3,980	3,106	-22%	4,047	3,865	-5%
Industry and export supply	84	84	0%	97	55	-43%	96	95	-1%
Total fuel volumes (m litres)	4,120	4,095	-1%	4,077	3,162	-22%	4,143	3,960	-4%
GM excl supply (cpl)	16.3	16.2	0%	15.2	17.5	15%	15.1	15.6	3%
GM incl refining (cpl)	17.5	17.5	0%	16.6	18.2	10%	16.5	17.1	3%
Gross profit make-up									
Fuels gross profit	656	650	-1%	605	544	-10%	612	602	-2%
Refining gross profit	48	48	0%	55	21	-61%	58	59	2%
Non-fuel gross profit	77	77	0%	80	60	-25%	83	72	-12%
NZR dividend	1	1	0%	-	-	-	2	2	0%
Flick gross profit	4	4	0%	6	6	0%	8	8	0%
	785	780	-1%	746	632	-15%	762	743	-3%

Source: Forsyth Barr analysis

Investment view

The one-off hit to our DCF valuation is -50cps (-11%) to \$3.85 (including the fall in ZEL's Refining NZ investment). The current share price of \$2.97 is factoring a one-off hit to petrol/diesel volumes of --55%.

Whilst the expected temporary ceasing of dividends is disappointing, move out a year and a dividend of 30cps represents a cash dividend yield of 10.1% (gross yield of 14.0%). In an environment with very low interest rates for a long period of time, that will appear increasingly attractive to yield hungry investors.

We have lowered our target price -46cps to \$4.00, but retain our OUTPERFORM rating. We believe ZEL has the balance sheet to weather the current COVID-19 induced storm.

Investment Summary

Our rating is OUTPERFORM. Z Energy (ZEL) is offering investors good value, with the market pricing in downside that we do not believe is likely to eventuate. Whilst there is a high degree of uncertainty in the current environment, ZEL is a strong business that we expect will come out of the COVID-19 crisis stronger than it went in.

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 cashflow 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 (albeit that is not the case currently). However, volumes are important for maintaining supply chain economics.
- **COVID-19 uncertainty:** The outbreak of COVID-19 is causing significant uncertainty. On the positive side, falling oil prices helps ZEL's short-term retail margins. Jet fuel volumes are the most impacted, but petrol and diesel will also see a significant demand drop. We expect the demand declines to be relatively short-lived.

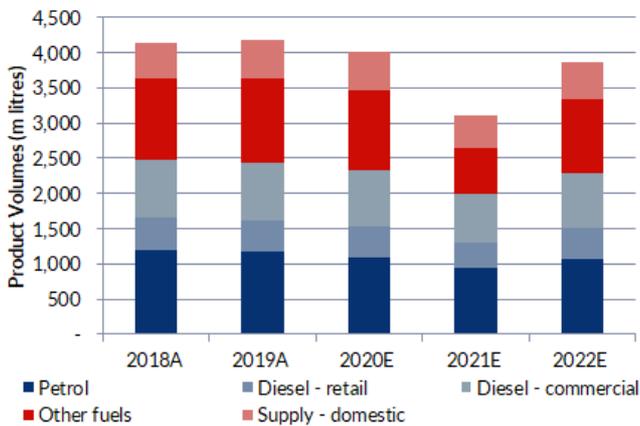
Financial structure

- **Dividend outlook:** The COVID-19 crisis is likely to force the Board to reconsider its dividend policy. After a temporary dividend suspension, we expect dividends will resume at ~30cps.
- **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.

Risk factors

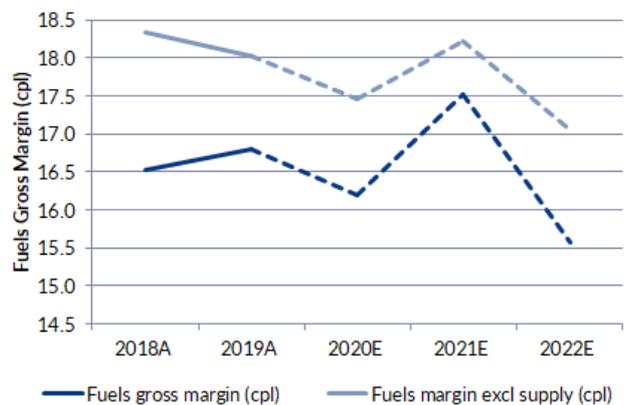
- **Long-term threat to industry volumes:** Increased vehicle efficiency and the threat from electric vehicles will pressure industry volumes. However, the near-term risks are low with industry volumes growing.
- **Retail Fuel Market Study (RFMS):** The RFMS has found that the retail fuel sector is over-earning 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 14. Fuel sales volumes



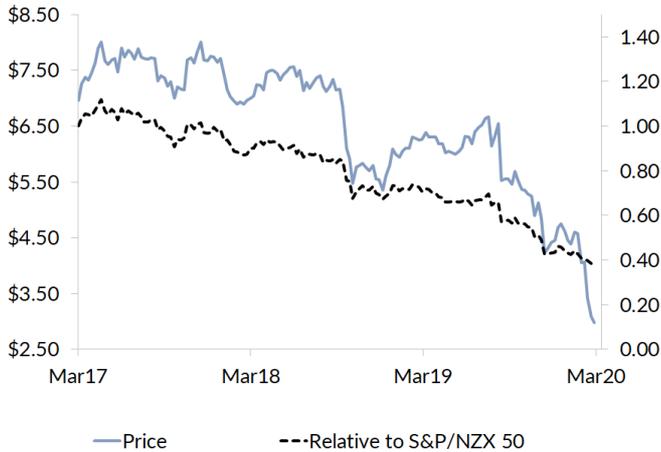
Source: ZEL, Forsyth Barr analysis

Figure 15. Gross fuel margins



Source: ZEL, Forsyth Barr analysis

Figure 16. Price performance



Source: Eikon, Forsyth Barr analysis

Figure 17. Substantial shareholders

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

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

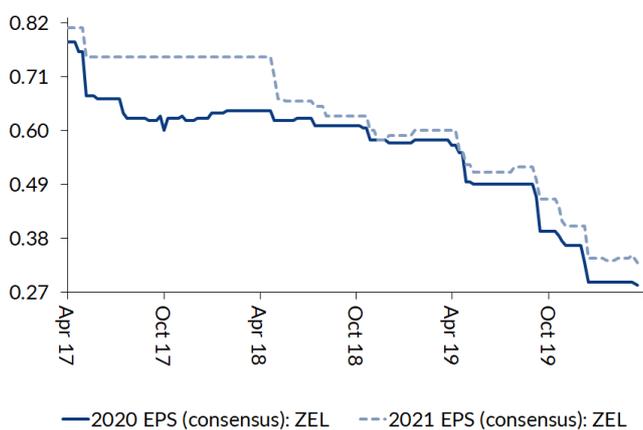
Figure 18. International valuation comparisons

Company (metrics re-weighted to reflect ZEL's balance date - March)	Code	Price	Mkt Cap (m)	PE		EV/EBITDA		EV/EBIT		Cash Yld 2021E
				2020E	2021E	2020E	2021E	2020E	2021E	
Z Energy	ZEL NZ	NZ\$2.98	NZ\$1,192	8.7x	20.8x	5.4x	7.6x	9.0x	16.2x	6.7%
SUBURBAN PROPANE PARTNERS LP	SPH US	US\$10.78	US\$669	9.7x	9.4x	7.8x	7.8x	14.2x	14.8x	22.3%
WORLD FUEL SERVICES CORP	INT US	US\$22.74	US\$1,487	8.3x	n/a	4.9x	n/a	6.9x	n/a	n/a
Contact Energy*	CEN NZ	NZ\$4.80	NZ\$3,447	14.2x	14.1x	9.5x	9.4x	18.0x	18.2x	8.1%
Mercury*	MCY NZ	NZ\$3.80	NZ\$5,177	21.9x	19.7x	12.5x	12.1x	21.0x	20.1x	4.2%
Trustpower*	TPW NZ	NZ\$4.53	NZ\$1,418	16.9x	14.1x	10.5x	9.5x	13.4x	11.8x	7.5%
Meridian Energy*	MEL NZ	NZ\$3.87	NZ\$9,919	20.0x	21.5x	13.2x	13.8x	20.5x	22.3x	5.6%
Genesis Energy*	GNE NZ	NZ\$2.01	NZ\$2,069	12.7x	11.1x	9.1x	8.4x	22.6x	20.5x	8.7%
CALTEX AUSTRALIA	CTX AT	A\$19.00	A\$4,744	12.2x	10.5x	6.2x	5.7x	10.0x	8.8x	5.8%
VIVA ENERGY GROUP	VEA AT	A\$1.20	A\$2,333	18.9x	12.4x	8.4x	6.9x	21.8x	13.8x	5.6%
Compco Average:				15.0x	14.1x	9.1x	9.2x	16.5x	16.3x	8.5%
ZEL Relative:				-42%	48%	-40%	-17%	-45%	-0%	-21%

EV = Current Market Cap + Actual Net Debt

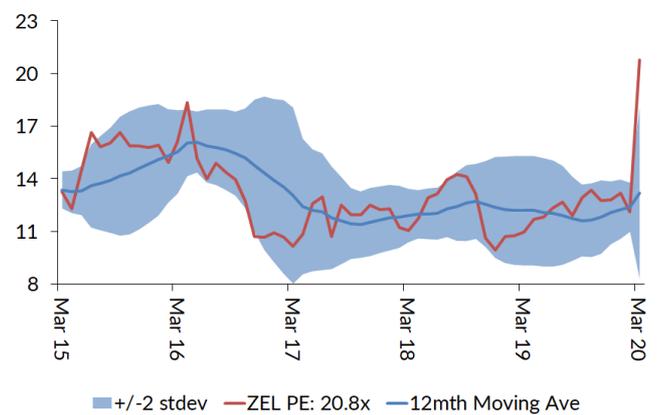
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (ZEL) companies fiscal year end

Figure 19. Consensus EPS momentum (NZ\$)



Source: Eikon, Forsyth Barr analysis

Figure 20. One year forward PE (x)



Source: Eikon, Forsyth Barr analysis

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