

Chorus

One Regulatory Step Back

MATT HENRY CFA

 matthew.henry@forsythbarr.co.nz
 +64 9 368 0115

OUTPERFORM

The regulatory picture for Chorus (CNU) took a dent with the Commerce Commission's (CC) updated draft reasons paper on the "input methodologies" (IMs) which feed into the regulatory determination for CNU's new ultra-fast fibre broadband (UFB) network. From a CNU perspective, the paper has one negative implication relative to the CC's draft published in November around the deductibility of Crown financing. We acknowledge there remains a material uncertainty in the outcome of the UFB regulatory process (which will not be finalised until 3Q/4Q 2021). However, given our base case expectation of an attractive c.9-10% free cash flow yield once the UFB network is complete, we see a margin of safety in the share price. Maintain OUTPERFORM.

| NZX Code | CNU | Financials: Jun/ | 19A | 20E | 21E | 22E | Valuation (x) | 19A | 20E | 21E | 22E |
|--------------------|---------------------|------------------------------|-------|------|-------|-------|-------------------|------|------|------|------|
| Share price | NZ\$7.25 | NPAT* (NZ\$m) | 53.0 | 55.6 | 47.7 | 42.5 | EV/EBITDA | 8.7 | 8.8 | 8.9 | 8.8 |
| Target price | NZ\$7.60 | EPS* (NZc) | 12.2 | 12.6 | 10.7 | 9.5 | EV/EBIT | 22.8 | 22.6 | 24.1 | 24.3 |
| Risk rating | High | EPS growth* (%) | -39.7 | 3.1 | -14.8 | -10.9 | PE | 59.4 | 57.6 | 67.7 | 76.0 |
| Issued shares | 439.3m | DPS (NZc) | 23.0 | 24.0 | 25.0 | 30.0 | Price / NTA | 4.1 | 4.3 | 4.7 | 5.3 |
| Market cap | NZ\$3,185m | Imputation (%) | 100 | 100 | 100 | 43 | Cash div yld (%) | 3.2 | 3.3 | 3.4 | 4.1 |
| Avg daily turnover | 416.0k (NZ\$2,582k) | *Based on normalised profits | | | | | Gross div yld (%) | 4.4 | 4.6 | 4.8 | 4.8 |

ComCom about turn on Crown financing cost

Under the regulatory framework, the benefit CNU receives from Crown financing (effectively interest free debt) is deducted in determining the "maximum allowable revenue" (MAR) it is allowed to earn on the UFB. The CC has shifted (largely back to) its view to calculate this benefit at WACC (pre-2022) and WACC less 25bp (post-2022) vs. previously at the (lower) cost of debt. All-else-equal, we estimate the change would result in:

1. A c.NZ\$100m reduction (from c.NZ\$1.2b to NZ\$1.1b) in the financial loss asset included in the initial regulatory asset base (RAB).
2. No change to our medium-term forecasts (before FY25). We assume CNU does not fully earn its MAR until the second regulatory period starting in 2025.
3. A c.NZ\$10-25m pa reduction in allowable UFB earnings over the period FY25-35 (varying with the level of Crown financing).
4. A modest reduction to our terminal cash flow expectation once the Crown financing is fully repaid.
5. A c.NZ45cps reduction in our discounted cash flow valuation.

Regulatory clarity still a work-in-progress

To date, there have been both positive and negative changes for CNU in the UFB IMs process. We expect further submissions on and CC consideration of this issue. In our view, imposing a WACC-25bp return on Crown financing post-2022 incentivises CNU to repay earlier and replace it with debt (which, in turn, would result in higher prices for consumers). The CC recognises this risk and believes the 25bp discount is sufficient to counter this incentive. Our view is it is not. CNU has stated it views Crown financing as debt which, when repaid, will be replaced by interest-bearing debt. A final IMs decision paper is scheduled to be published on 13 October.

Today's announcement is a reminder that CNU is a long-dated business with substantial operating and financial leverage, and therefore, any assessment of the company's fundamental value can vary materially depending on the CC determination of the UFB maximum allowable revenue.

Investment Summary

We are attracted to CNU's fundamental value underpinned by the considerable long-term free cash flow we expect the company to generate once its ultra-fast broadband (UFB) fibre network is complete in 2022. We believe an FCF yield of >10% from FY24E onward could facilitate a significant lift in CNU's dividend. OUTPERFORM.

Business quality

- **Building a high quality fibre network:** CNU is building c.75% of the government-sponsored ultrafast broadband (UFB) fibre network which will allow c.87% of NZers to access fibre-to-the-home by 2022. Uptake of the fibre network has been strong and is now >55% and expanding rapidly, albeit at a cost to CNU shedding its legacy copper customer base.
- **Fibre regulatory regime key value driver:** The most material medium-term impact on CNU's valuation is the implementation of a new regulatory regime for the UFB network which commences 1 January 2022. The next step is a final input methodologies decision paper scheduled to be published on 13 October.

Earnings and cashflow outlook

- **Stabilising financials:** CNU's revenue/EBITDA has been falling as it sheds share with copper customers transitioning to fibre outside its regions, and to fixed wireless broadband. We expect both earnings and debt should start to stabilise with capex having peaked in FY19, fibre revenue surpassing copper in FY20, and CNU to deliver positive free cash flow from FY22 as the UFB capex moderates.

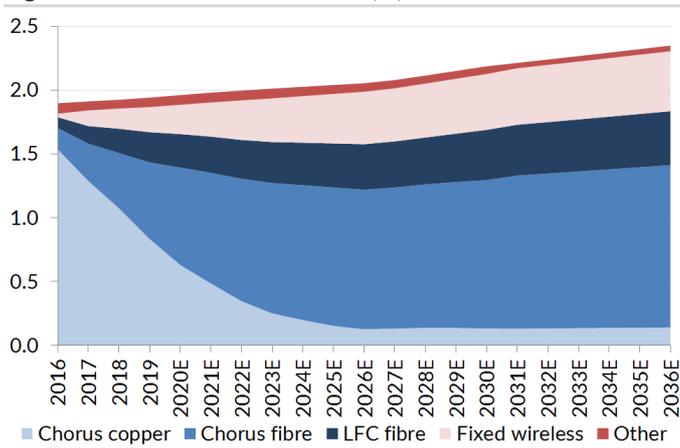
Financial structure

- **Balance sheet:** CNU debt has been rising as the UFB network has been rolled out. CNU expects debt to peak in FY21. Our FY20/21E net debt/EBITDA of 4.1/4.1x (includes the present value of interest free government funding) compares to S&P's and Moody's long-term hurdle of 4.75x and 4.2x respectively. We expect rating agencies to remain comforted by the clear path to debt reduction post UFB build.

Risk factors

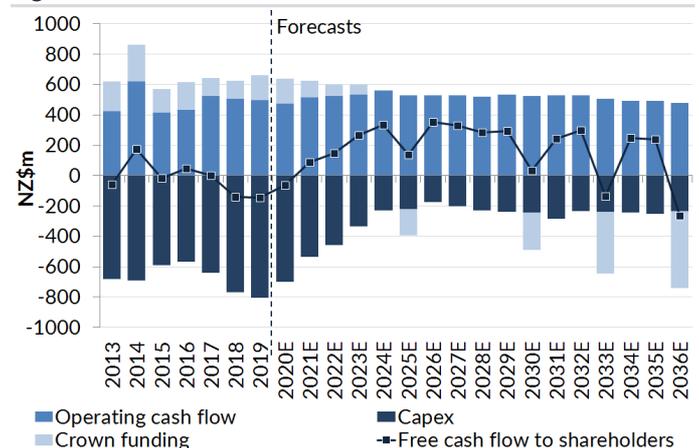
- **Implementation of the new fibre regulatory regime:** CNU is a long-dated business with considerable operating and financial leverage, and therefore significant valuation sensitivity to its allowable regulated fibre revenue.
- **Competition from wireless technologies, and loss of market share to mobile/5G:** We are watchful of improving wireless technology as a long-term risk to CNU. At this time we believe fixed services over wireless technology will be a niche, rather than mass-market product.

Figure 1. NZ fixed line connections (m)



Source: Company reports, Forsyth Barr analysis

Figure 2. Cash flow



Source: Company reports, Forsyth Barr analysis

Figure 3. Price performance


Source: Forsyth Barr analysis

Figure 4. Substantial shareholders

| Shareholder | Latest Holding |
|--------------------------------|----------------|
| L1 Capital Partners Pty | 11.0% |
| Commonwealth Bank of Australia | 6.5% |
| The Vanguard Group | 5.4% |

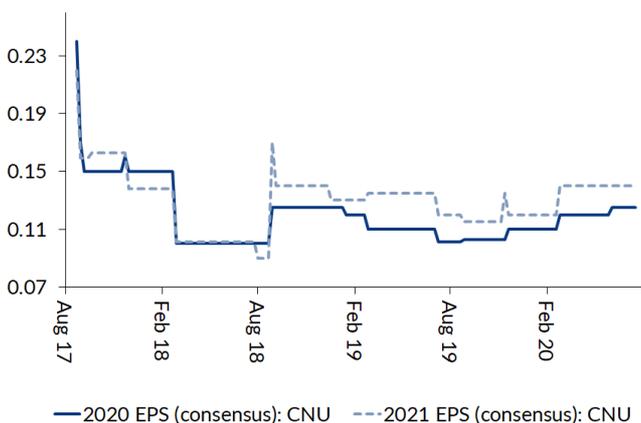
Source: NZX, Forsyth Barr analysis, NOTE: based on SPH notices only

Figure 5. International valuation comparisons

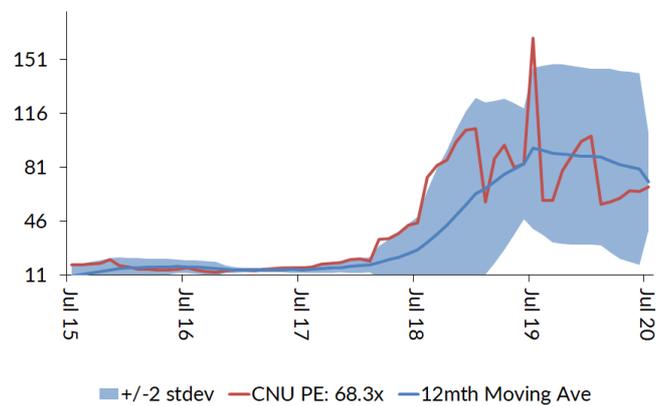
| Company | Code | Price | Mkt Cap (m) | PE | | EV/EBITDA | | EV/EBIT | | Cash Yld 2021E |
|----------------------------|---------------|-----------------|------------------|----------------|----------------|--------------|-------------|--------------|--------------|----------------|
| | | | | 2020E | 2021E | 2020E | 2021E | 2020E | 2021E | |
| Chorus | CNU NZ | NZ\$7.25 | NZ\$3,185 | >50x | >50x | 8.7x | 8.7x | 22.3x | 23.5x | 3.4% |
| SPARK NZ * | SPK NZ | NZ\$4.93 | NZ\$9,057 | 22.5x | 21.7x | 9.4x | 9.3x | 16.5x | 16.2x | 5.1% |
| VECTOR * | VCT NZ | NZ\$3.82 | NZ\$3,803 | 28.1x | 31.2x | 11.0x | 11.1x | 20.1x | 20.8x | 4.3% |
| AUSNET SERVICES | AST AT | A\$1.74 | A\$6,512 | 22.5x | 24.3x | 13.2x | 13.3x | 21.7x | 22.4x | 5.3% |
| SPARK INFRASTRUCTURE GROUP | SKI AT | A\$2.27 | A\$3,908 | 41.4x | 44.9x | 51.3x | 6.2x | 57.2x | 17.9x | 5.8% |
| TELSTRA CORP | TLS AT | A\$3.39 | A\$40,318 | 19.3x | 19.9x | 6.8x | 7.1x | 15.5x | 16.1x | 4.6% |
| TPG CORP | TPM AT | A\$8.93 | A\$8,048 | 32.1x | 36.1x | 13.1x | 8.7x | 22.5x | 19.7x | 1.3% |
| VOCUS GROUP | VOC AT | A\$2.95 | A\$1,831 | 17.2x | 16.9x | 8.3x | 7.9x | 15.2x | 15.5x | 0.2% |
| BT GROUP PLC | BT/ALN | £1.14 | £11,315 | 6.3x | 5.7x | 4.1x | 4.0x | 9.4x | 9.3x | 2.4% |
| NETLINK NBN TRUST | NETLINK SP | \$0.96 | \$3,722 | 46.2x | 40.7x | 16.1x | 15.5x | 45.1x | 39.9x | 5.3% |
| Comppo Average: | | | | 26.2x | 26.8x | 14.8x | 9.2x | 24.8x | 19.7x | 3.8% |
| CNU Relative: | | | | n/a | n/a | -41% | -6% | -10% | 19% | -9% |

EV = Current Market Cap + Actual Net Debt

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

Figure 6. Consensus EPS momentum (NZ\$)


Source: Forsyth Barr analysis

Figure 7. One year forward PE (x)


Source: Forsyth Barr analysis

Analyst certification: The research analyst(s) primarily responsible for the preparation and content of this publication ("Analysts") are named on the first page of this publication. Each such Analyst certifies (other than in relation to content or views expressly attributed to another analyst) that (i) the views expressed in this publication accurately reflect their personal views about each issuer and financial product referenced and were prepared in an independent manner, including with respect to Forsyth Barr Limited and its related companies; and (ii) no part of the Analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by that Analyst in this report.

Analyst holdings: The following Analyst(s) have a threshold interest in the financial products referred to in this publication: Matt Henry. For these purposes, a threshold interest is defined as being a holder of more than \$50,000 in value or 1% of the financial products on issue, whichever is the lesser.

Ratings distributions: As at 22 Jul 2020, Forsyth Barr's research ratings were distributed as follows:

| OUTPERFORM | NEUTRAL | UNDERPERFORM |
|-------------------|----------------|---------------------|
| 44.2% | 42.3% | 13.5% |

Forsyth Barr's research ratings are OUTPERFORM, NEUTRAL, and UNDERPERFORM. The ratings are relative to our other equity security recommendations across our New Zealand market coverage and are based on risk-adjusted Estimated Total Returns for the securities in question. Risk-adjusted Estimated Total Returns are calculated from our assessment of the risk profile, expected dividends and target price for the relevant security.

Disclosure: Forsyth Barr Limited and its related companies (and their respective directors, officers, agents and employees) ("Forsyth Barr") may have long or short positions or otherwise have interests in the financial products referred to in this publication, and may be directors or officers of, and/or provide (or be intending to provide) investment banking or other services to, the issuer of those financial products (and may receive fees for so acting). Forsyth Barr is not a registered bank within the meaning of the Reserve Bank of New Zealand Act 1989. Forsyth Barr may buy or sell financial products as principal or agent, and in doing so may undertake transactions that are not consistent with any recommendations contained in this publication. Other Forsyth Barr business units may hold views different from those in this publication; any such views will generally not be brought to your attention. Forsyth Barr confirms no inducement has been accepted from the issuer(s) that are the subject of this publication, whether pecuniary or otherwise, in connection with making any recommendation contained in this publication. In preparing this publication, non-financial assistance (for example, access to staff or information) may have been provided by the issuer(s) being researched.

Investment banking engagements: Other than confidential engagements, Forsyth Barr has within the past 12 months been engaged to provide investment banking services to the following issuers that are the subject of this publication: SKT SPK

Not personalised financial advice: The recommendations and opinions in this publication do not take into account your personal financial situation or investment goals. The financial products referred to in this publication may not be suitable for you. If you wish to receive personalised financial advice, please contact your Forsyth Barr Investment Adviser. The value of financial products may go up and down and investors may not get back the full (or any) amount invested. Past performance is not necessarily indicative of future performance. Disclosure statements for Forsyth Barr Investment Advisers are available on request and free of charge.

Disclaimer: This publication has been prepared in good faith based on information obtained from sources believed to be reliable and accurate. However, that information has not been independently verified or investigated by Forsyth Barr. Forsyth Barr does not make any representation or warranty (express or implied) that the information in this publication is accurate or complete, and, to the maximum extent permitted by law, excludes and disclaims any liability (including in negligence) for any loss which may be incurred by any person acting or relying upon any information, analysis, opinion or recommendation in this publication. Forsyth Barr does not undertake to keep current this publication; any opinions or recommendations may change without notice to you. Any analyses or valuations will typically be based on numerous assumptions; different assumptions may yield materially different results. Nothing in this publication should be construed as a solicitation to buy or sell any financial product, or to engage in or refrain from doing so, or to engage in any other transaction. This publication is not intended to be distributed or made available to any person in any jurisdiction where doing so would constitute a breach of any applicable laws or regulations or would subject Forsyth Barr to any registration or licensing requirement within such jurisdiction.

Terms of use: Copyright Forsyth Barr Limited. You may not redistribute, copy, revise, amend, create a derivative work from, extract data from, or otherwise commercially exploit this publication in any way. By accessing this publication via an electronic platform, you agree that the platform provider may provide Forsyth Barr with information on your readership of the publications available through that platform.