

# Contact Energy

## Minor COVID-19 Symptoms

**ANDREW HARVEY-GREEN**

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

**SCOTT ANDERSON**

 scott.anderson@forsythbarr.co.nz  
 +64 4 914 2219

### OUTPERFORM

Whilst the electricity sector is facing some COVID-19 headwinds, they are relatively minor and the earnings impact on Contact Energy's (CEN) EBITDAF is ~-2.2% over the next two years. Early indications are encouraging that electricity demand will return close to normal, meaning the greatest downside risk is from bad debts. With the impact of COVID-19 and subsequent economic downturn expected to be minor relative to other sectors, we expect the electricity sector to benefit from the lower interest rate environment. We have increased our target multiples and lowered our target dividend yield, resulting in a modest increase (+15cps to \$8.15) in our target price. We retain our OUTPERFORM rating.

#### Figure 1. What's changed:

**FY20/FY21 EBITDAF:** Lowered -\$10m/-\$10m (-2.3%/-2.2%) to \$431m/\$463m respectively  
**Target price:** Increased +15cps (+1.9%) to \$8.15

NZX Code	CEN	Financials: Jun/	19A	20E	21E	22E	Valuation (x)	19A	20E	21E	22E
Share price	NZ\$6.22	NPAT* (NZ\$m)	277.5	224.5	243.9	249.4	EV/EBITDA	10.8	12.5	11.7	11.4
Target price	NZ\$8.15	EPS* (NZc)	38.8	31.4	34.1	34.8	EV/EBIT	17.9	24.9	22.7	22.9
Risk rating	Low	EPS growth* (%)	21.4	-19.1	8.6	2.3	PE	16.0	19.8	18.3	17.8
Issued shares	715.5m	DPS (NZc)	39.0	39.0	39.0	39.0	Price / NTA	1.9	2.0	2.2	2.3
Market cap	NZ\$4,451m	Imputation (%)	64	59	65	65	Cash div yld (%)	6.3	6.3	6.3	6.3
Avg daily turnover	1,088k (NZ\$7,966k)	*Based on normalised profits					Gross div yld (%)	7.8	7.7	7.9	7.9

#### Trading outlook slightly softer, but not materially so

We have trimmed our outlook for CEN with several factors impacting our forecast including: lower wholesale electricity price outlook, modest fall in FY20 electricity demand (due in part to lower sales volumes than expected in February and March), increased risk of bad debts in FY21. We have also pushed back the likely construction of Tauhara a year, which has a minor impact on FY22 earnings. We discuss the wholesale market outlook and assumptions changes in more detail in the May 2020 edition of Power Points.

#### Small risk that dividend will get trimmed on lower earnings, but CEN will be reluctant to do so

We have left our dividend forecast unchanged at 39cps, consistent with CEN guidance. However, we believe it will now be harder for CEN to achieve underlying EBITDAF earnings of \$480m (which we did not expect until FY22). The lower wholesale electricity price outlook will impact on the price commercial customers are being signed up on and FY21, in particular, is likely to be impacted by an increase in bad debts. Whilst earnings of \$480m implies a slightly higher dividend than 39cps, a \$20m decline in EBITDAF equates to ~2cps in dividend.

#### Lifting sector outlook as defensive nature of electricity is increasingly attractive

Whilst our near-term earnings outlook is slightly softer, we believe that the electricity sector is becoming increasingly attractive relative to other market opportunities. Thinking beyond COVID-19, we expect investments that offer a robust dividend will be sought after. Traditional stocks that were previously viewed as safe havens, such as property, SkyCity and airports, face greater downside issues than the electricity stocks. We have, therefore, lowered our target gross dividend yield (-0.5% to 5.75%) and lifted our target multiples modestly (adjusted PE up +2x to 24x), which has the effect of offsetting our modest earnings cuts and lifting our target price +15cps (+1.9%) to \$8.15.

**Contact Energy Limited (CEN)**

Priced as at 06 May 2020 (NZ\$)

**6.22**
**12-month target price (NZ\$)\***
**8.15**

Expected share price return	31.0%
Net dividend yield	6.3%
Estimated 12-month return	37.3%

**Spot valuations (NZ\$)**

1. DCF	7.37
2. Market multiples	8.01
3. Dividend yield	8.80

**Key WACC assumptions**

Risk free rate	2.00%
Equity beta	0.88
WACC	6.8%
Terminal growth	1.5%

**DCF valuation summary (NZ\$m)**

Total firm value	6,541
(Net debt)/cash	(1,197)
Less: Capitalised operating leases	
Value of equity	5,344

<b>Profit and Loss Account (NZ\$m)</b>	<b>2018A</b>	<b>2019A</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>	<b>Valuation Ratios</b>	<b>2018A</b>	<b>2019A</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>
Sales revenue	2,275.0	2,519.0	1,945.2	2,032.0	2,112.5	EV/EBITDA (x)	12.4	10.8	12.5	11.7	11.4
<b>Normalised EBITDA</b>	<b>479.0</b>	<b>518.0</b>	<b>431.4</b>	<b>462.8</b>	<b>474.0</b>	EV/EBIT (x)	22.5	17.9	24.9	22.7	22.9
Depreciation and amortisation	(220.0)	(205.0)	(215.5)	(224.2)	(237.2)	PE (x)	19.5	16.0	19.8	18.3	17.8
<b>Normalised EBIT</b>	<b>264.0</b>	<b>313.0</b>	<b>215.8</b>	<b>238.6</b>	<b>236.8</b>	Price/NTA (x)	1.9	1.9	2.0	2.2	2.3
Net interest	(84.0)	(70.0)	(56.6)	(55.0)	(57.2)	Free cash flow yield (%)	6.7	7.6	5.1	6.2	3.5
Depreciation capex adjustment	96	102	110	112	120	Net dividend yield (%)	5.1	6.3	6.3	6.3	6.3
Tax	(48.0)	(72.0)	(45.2)	(51.4)	(50.3)	Gross dividend yield (%)	6.1	7.8	7.7	7.9	7.9
Minority interests	0	0	0	0	0						
<b>Adjusted normalised NPAT</b>	<b>228.6</b>	<b>277.5</b>	<b>224.5</b>	<b>243.9</b>	<b>249.4</b>	<b>Capital Structure</b>	<b>2018A</b>	<b>2019A</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>
Abnormals/other	(94)	67	(108)	(112)	(120)	Interest cover EBIT (x)	3.4	4.9	4.2	5.0	5.0
<b>Reported NPAT</b>	<b>135.0</b>	<b>345.0</b>	<b>116.1</b>	<b>132.2</b>	<b>129.3</b>	Interest cover EBITDA (x)	5.7	7.4	7.6	8.4	8.3
Normalised EPS (cps)	31.9	38.8	31.4	34.1	34.8	Net debt/ND+E (%)	34.1	24.8	27.0	28.1	31.8
DPS (cps)	32.0	39.0	39.0	39.0	39.0	Net debt/EBITDA (x)	2.9	1.8	2.3	2.1	2.3
<b>Growth Rates</b>	<b>2018A</b>	<b>2019A</b>	<b>2020A</b>	<b>2021A</b>	<b>2022A</b>	<b>Key Ratios</b>	<b>2018A</b>	<b>2019A</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>
Revenue (%)	9.4	10.7	-22.8	4.5	4.0	Return on assets (%)	5.0	9.8	4.5	5.1	5.1
EBITDA (%)	-4.4	8.1	-16.7	7.3	2.4	Return on equity (%)	4.9	6.3	4.4	5.3	5.5
EBIT (%)	-11.4	18.6	-31.0	10.5	-0.8	Return on funds employed (%)	4.6	9.5	4.4	5.0	5.0
Normalised NPAT (%)	9.0	21.4	-19.1	8.6	2.3	EBITDA margin (%)	21.1	20.6	22.2	22.8	22.4
Normalised EPS (%)	9.0	21.4	-19.1	8.6	2.3	EBIT margin (%)	11.6	12.4	11.1	11.7	11.2
Ordinary DPS (%)	23.1	21.9	0.0	0.0	0.0	Capex to sales (%)	3.6	2.5	4.6	3.2	10.2
						Capex to depreciation (%)	37	31	41	29	91
						Imputation (%)	48	64	59	65	65
						Pay-out ratio (%)	100	101	124	114	112
<b>Cash Flow (NZ\$m)</b>	<b>2018A</b>	<b>2019A</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>	<b>Operating Performance</b>	<b>2018A</b>	<b>2019A</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>
<b>EBITDA</b>	<b>479.0</b>	<b>518.0</b>	<b>431.4</b>	<b>462.8</b>	<b>474.0</b>	Hydro generation (GWh)	3,479	4,232	3,771	3,887	3,887
Working capital change	37.0	(20.0)	(10.1)	(6.0)	14.8	Geothermal generation (GWh)	3,323	3,257	3,331	3,324	3,324
Interest & tax paid	(110.0)	(111.0)	(106.0)	(114.9)	(116.1)	Thermal generation (GWh)	1,812	1,422	1,139	1,208	1,379
Other	(27.0)	14.0	0	0	0	<b>Total Generation (GWh)</b>	<b>8,614</b>	<b>8,911</b>	<b>8,241</b>	<b>8,418</b>	<b>8,589</b>
<b>Operating cash flow</b>	<b>379.0</b>	<b>401.0</b>	<b>315.3</b>	<b>341.9</b>	<b>372.7</b>	GWAP (\$/MWh)	85	129	84	84	83
Capital expenditure	(82.0)	(63.0)	(89.0)	(65.0)	(216.3)	Gas consumed (PJ)	17.5	13.9	10.9	11.4	12.9
(Acquisitions)/divestments	6.0	382.0	0	0	0	Gas price (\$/GJ)	6.1	7.1	7.5	8.0	8.1
Other	(7.0)	0	0	0	0						
<b>Funding available/(required)</b>	<b>296.0</b>	<b>720.0</b>	<b>226.3</b>	<b>276.9</b>	<b>156.4</b>	Retail electricity volumes (GWh)	6,997	6,554	5,667	5,973	6,211
Dividends paid	(201.0)	(251.0)	(279.1)	(279.1)	(279.1)	Electricity customers (000)	413	411	407	405	403
Equity raised/(returned)	1.0	0	0	0	0	Average usage/customer (MWh)	8.7	8.6	8.6	8.6	8.6
<b>(Increase)/decrease in net debt</b>	<b>96.0</b>	<b>469.0</b>	<b>(52.9)</b>	<b>(2.2)</b>	<b>(122.7)</b>	Average retail price (\$/MWh)	242	244	245	250	255
						LWAP (\$/MWh)	91	138	92	91	90
						LWAP/GWAP	1.07	1.07	1.10	1.08	1.08
<b>Balance Sheet (NZ\$m)</b>	<b>2018A</b>	<b>2019A</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>	Retail gas volumes (PJ)	2.9	3.1	3.1	3.1	3.2
Working capital	(22.0)	(3.0)	6.1	11.2	(4.6)	Gas customers (000)	65	67	66	66	66
Fixed assets	4,221.0	4,094.0	3,971.5	3,816.2	3,799.4	Average gas sales price (\$/GJ)	24.6	23.6	23.9	24.8	25.2
Intangibles	441.0	425.0	425.0	425.0	425.0						
Right of use asset	32.0	32.0	32.0	32.0	32.0						
Other assets	404.0	132.0	132.0	132.0	132.0						
<b>Total funds employed</b>	<b>5,076.0</b>	<b>4,680.0</b>	<b>4,566.6</b>	<b>4,416.4</b>	<b>4,383.7</b>						
Net debt/(cash)	1,410.0	918.0	970.9	973.1	1,095.9						
Lease liability	38.0	25.0	25.0	25.0	25.0						
Other liabilities	901.0	955.0	946.8	933.1	917.0						
Shareholder's funds	2,727.0	2,782.0	2,623.9	2,485.2	2,345.8						
Minority interests	0	0	0	0	0						
<b>Total funding sources</b>	<b>5,076.0</b>	<b>4,680.0</b>	<b>4,566.6</b>	<b>4,416.4</b>	<b>4,383.7</b>						

## Summary forecast changes

Figure 2. Summary forecast changes

	FY20			FY21			FY22		
	Old	New	% chg	Old	New	% chg	Old	New	% chg
Revenue	2,168	1,945	-10.3%	2,229	2,032	-8.8%	2,246	2,112	-5.9%
<b>EBITDAF</b>	<b>441</b>	<b>431</b>	<b>-2.3%</b>	<b>473</b>	<b>463</b>	<b>-2.2%</b>	<b>490</b>	<b>474</b>	<b>-3.3%</b>
EBIT	226	216	-4.4%	245	239	-2.5%	247	237	-4.1%
Reported NPAT	124	116	-6.0%	134	132	-1.4%	128	129	0.6%
<b>Normalised NPAT</b>	<b>122</b>	<b>115</b>	<b>-6.1%</b>	<b>134</b>	<b>132</b>	<b>-1.4%</b>	<b>128</b>	<b>129</b>	<b>0.6%</b>
<b>Adjusted NPAT</b>	<b>232</b>	<b>224</b>	<b>-3.2%</b>	<b>249</b>	<b>244</b>	<b>-2.0%</b>	<b>253</b>	<b>249</b>	<b>-1.3%</b>
EPS	32.4	31.4	-3.2%	34.8	34.1	-2.0%	35.3	34.9	-1.3%
DPS	39.0	39.0	0.0%	39.0	39.0	0.0%	39.0	39.0	0.0%
Generation (GWh)	8,718	8,241	-5.5%	8,910	8,418	-5.5%	9,420	8,589	-8.8%
Electricity Wholesale Price (\$/MWh)	\$104.5	\$84.1	-19.5%	\$100.6	\$84.4	-16.0%	\$88.3	\$83.3	-5.6%
Retail Demand (GWh)	5,888	5,667	-3.8%	6,121	5,973	-2.4%	6,370	6,211	-2.5%

Source: Forsyth Barr analysis

## Investment Summary

Our rating is **OUTPERFORM**. Notwithstanding another challenging year, we view CEN as offering some of the best value amongst the generator/retailers. We believe the NZAS closure risk is more than priced into the share price. CEN is offering an attractive dividend yield and has one of the best potential development projects (Tauhara) in the country.

### Key drivers

- **Wholesale electricity prices and the electricity demand/supply balance:** The wholesale electricity price is the key driver of retail and commercial prices and therefore the key value driver. The electricity demand/supply balance and the cost of new generation underpin the wholesale price. Currently the NZ market is balanced.
- **Retail margins:** In recent years intense retail competition and new entrant retailers have eroded retail margins. Strong margins support profitability.
- **Hydrology:** Short-term earnings are impacted by hydrology. CEN prefers wet conditions as it lowers its average cost of generation. However, CEN's thermal fleet provides it with some downside protection from dry conditions.

### Other key company and industry issues

- **Increased carbon costs:** Following changes to the Emissions Trading Scheme, CEN has to relinquish more carbon credits, and carbon prices have increased materially. This is a modest headwind for FY20.

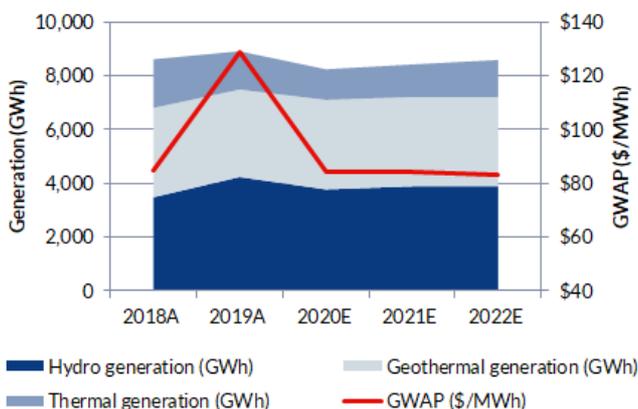
### Upcoming catalysts/events

- **Geothermal development:** CEN has one of the best generation development opportunities in its Tauhara geothermal field. With modest electricity demand growth expected and CEN likely to close its base-load gas plant within three years, there is a strong chance it develops this field.
- **Success of cost-out:** CEN has successfully removed operating and capital costs over the past four years. It believes additional cost-out opportunities exist; delivering on these will be important for earnings.

### Key risks

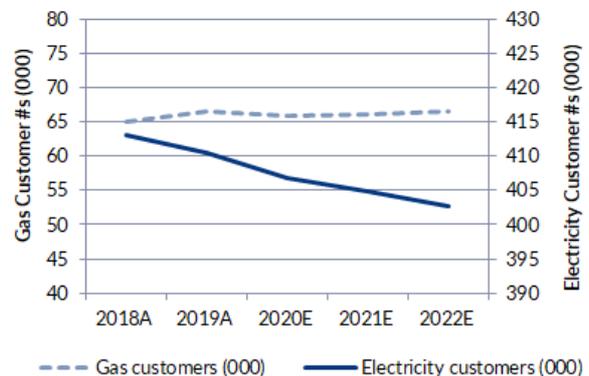
- **Geothermal development:** CEN has one of the best generation development opportunities in its Tauhara geothermal field. With modest electricity demand growth expected and CEN likely to close its base-load gas plant within three years, there is a strong chance it develops this field.
- **Success of cost-out:** CEN has successfully removed operating and capital costs over the past four years. It believes additional cost-out opportunities exist; delivering on these will be important for earnings.

**Figure 3. Generation volumes and average price received**



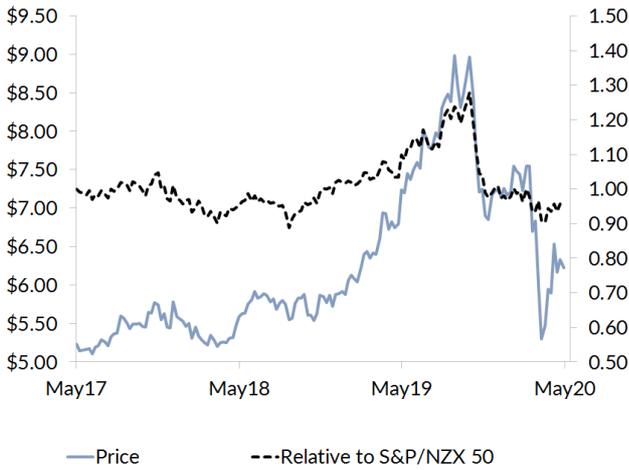
Source: CEN, Forsyth Barr analysis

**Figure 4. Customer numbers**



Source: CEN, Forsyth Barr analysis

**Figure 5. Price performance**



Source: Forsyth Barr analysis

**Figure 6. Substantial shareholders**

Shareholder	Latest Holding
BlackRock Investment Management	5.4%
ACC	5.1%
The Vanguard Group	5.0%

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

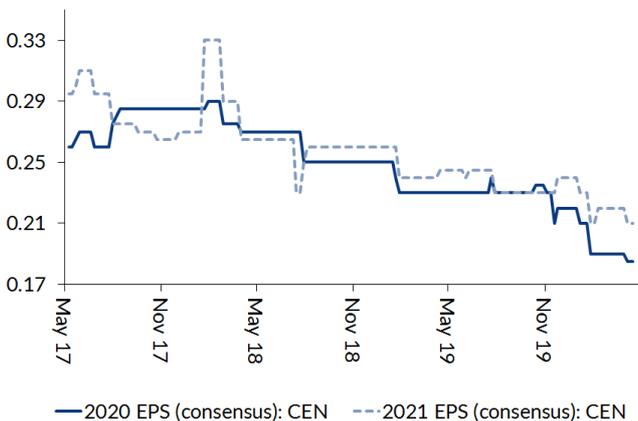
**Figure 7. International valuation comparisons**

Company	Code	Price	Mkt Cap (m)	PE		EV/EBITDA		EV/EBIT		Cash Yld
(metrics re-weighted to reflect CEN's balance date - June)										
				2020E	2021E	2020E	2021E	2020E	2021E	2021E
Contact Energy	CEN NZ	NZ\$6.22	NZ\$4,451	19.8x	18.3x	12.4x	11.6x	24.9x	22.5x	6.3%
Genesis Energy*	GNE NZ	NZ\$2.85	NZ\$2,957	18.0x	15.0x	11.5x	10.4x	30.1x	24.7x	6.1%
Meridian Energy*	MEL NZ	NZ\$4.82	NZ\$12,354	24.7x	27.4x	15.9x	17.1x	25.1x	27.8x	4.5%
Mercury*	MCY NZ	NZ\$4.59	NZ\$6,246	26.5x	22.9x	14.6x	14.0x	24.7x	23.2x	3.5%
Trustpower*	TPW NZ	NZ\$6.32	NZ\$1,978	22.6x	19.4x	13.2x	12.1x	16.6x	14.9x	5.4%
AGL ENERGY	AGL AT	A\$17.09	A\$10,752	13.2x	13.2x	6.5x	6.5x	10.1x	10.2x	5.7%
ORIGIN ENERGY	ORG AT	A\$4.89	A\$8,612	8.5x	17.8x	4.9x	6.5x	11.4x	20.2x	3.9%
<b>Compcop Average:</b>				<b>18.9x</b>	<b>19.3x</b>	<b>11.1x</b>	<b>11.1x</b>	<b>19.7x</b>	<b>20.2x</b>	<b>4.9%</b>
<b>CEN Relative:</b>				<b>5%</b>	<b>-5%</b>	<b>12%</b>	<b>5%</b>	<b>27%</b>	<b>12%</b>	<b>29%</b>

EV = Current Market Cap + Actual Net Debt

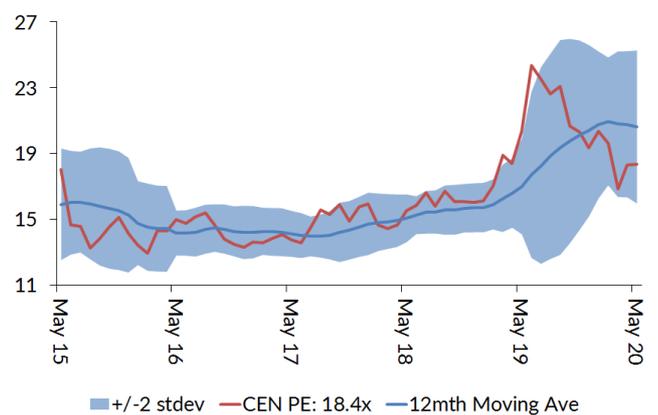
Source: \*Forsyth Barr analysis, Bloomberg Consensus, Compcop metrics re-weighted to reflect headline (CEN) companies fiscal year end

**Figure 8. Consensus EPS momentum (NZ\$)**



Source: Forsyth Barr analysis

**Figure 9. 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: N/A. 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 5 May 2020, Forsyth Barr's research ratings were distributed as follows:

<b>OUTPERFORM</b>	<b>NEUTRAL</b>	<b>UNDERPERFORM</b>
<b>44.0%</b>	<b>42.0%</b>	<b>14.0%</b>

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: IFT MCY TPW VCT

**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.