

Mercury

Rare Dividend Growth Coming

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OUTPERFORM

We are upgrading our Mercury (MCY) rating to OUTPERFORM from NEUTRAL. We expect MCY to perform well in an investment environment that will refocus on income after the near-term COVID-19 issues subside. MCY has the strongest dividend growth profile in the sector, courtesy of its under construction wind farm and a benign balance sheet. The expected investment sentiment in favour of defensive yield stocks outweighs the drop in short-term earnings. We lift our target price +7.6% to \$4.95.

Figure 1. What's changed

FY20/FY21 EBITDAF:	Lowered -\$8m/-\$12m (-1.7%/-2.2%) to \$493m/\$514m respectively
Target price:	Increased +35cps (+7.6%) to \$4.95
Rating:	Upgraded to OUTPERFORM from NEUTRAL

Source: Forsyth Barr analysis

NZX Code	MCY	Financials: Jun/	19A	20E	21E	22E	Valuation (x)	19A	20E	21E	22E
Share price	NZ\$4.50	NPAT* (NZ\$m)	239.0	229.5	263.8	278.0	EV/EBITDA	13.9	14.1	13.7	13.0
Target price	NZ\$4.95	EPS* (NZc)	17.6	16.9	19.4	20.4	EV/EBIT	23.3	24.2	23.1	21.3
Risk rating	Low	EPS growth* (%)	-6.4	-4.0	14.9	5.4	PE	25.6	26.7	23.2	22.0
Issued shares	1360.9m	DPS (NZc)	15.5	15.8	16.2	18.1	Price / NTA	1.8	1.8	1.8	1.8
Market cap	NZ\$6,117m	Imputation (%)	100	100	100	100	Cash div yld (%)	3.4	3.5	3.6	4.0
Avg daily turnover	1,053k (NZ\$5,032k)	*Based on normalised profits					Gross div yld (%)	4.8	4.9	5.0	5.6

Upgrading to OUTPERFORM on attractive yield profile with growth potential

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. Whilst MCY has the lowest headline dividend gross yield in the electricity sector, it has the highest expected three year dividend growth of +~30% following the construction of its Turitea wind farm. In addition, 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 (-0.75% to 4.25%) and lifted our target multiples modestly (adjusted PE up +3.5x to 27.5x), which has the effect of offsetting our modest earnings cuts and lifting our target price +35cps (+7.6%) to \$4.95. We are upgrading to OUTPERFORM.

Near-term earnings impact due to lack of water

We have lowered our FY20 EBITDAF forecast -\$8m (-1.7%) to \$493m with the main driver being expected lower hydro generation volumes. This is consistent with MCY's revised EBITDAF guidance of \$490m, down -\$10m, also due to it lowering its hydro generation guidance -100GWh to 3,800GWh. MCY's 3Q20 operating statistics were generally solid, with the expected lift in commercial pricing coming through, better than expected, at +19.9%. Looking out to FY21, the main drivers of the lower earnings forecast (EBITDAF down -2.2% to \$514m) are a lift in bad debts and the lower wholesale electricity price outlook.

Mercury NZ Limited (MCY)

Priced as at 06 May 2020 (NZ\$)

4.50

12-month target price (NZ\$)*						Spot valuations (NZ\$)					
Expected share price return						1. DCF					3.85
Net dividend yield						2. Market multiple					5.54
Estimated 12-month return						3. Dividend yield					5.41
Key WACC assumptions						DCF valuation summary (NZ\$m)					
Risk free rate						Total firm value					6,542
Equity beta						(Net debt)/cash					(1,211)
WACC						Less: Capitalised operating leases					
Terminal growth						Value of equity					5,330
Profit and Loss Account (NZ\$m)						Valuation Ratios					
Sales revenue	2018A	2019A	2020E	2021E	2022E	EV/EBITDA (x)	2018A	2019A	2020E	2021E	2022E
Normalised EBITDA	1,798.0	2,000.0	1,678.5	1,660.3	1,683.0	EV/EBIT (x)	12.6	13.9	14.2	13.7	13.0
Depreciation and amortisation	566.0	505.0	492.7	514.3	542.2	PE (x)	19.4	23.3	24.2	23.1	21.4
Normalised EBIT	(201.0)	(204.0)	(207.5)	(209.0)	(212.3)	Price/NTA (x)	24.0	25.6	26.7	23.2	22.0
Net interest	365.0	301.0	285.3	305.3	329.9	Free cash flow yield (%)	1.9	1.8	1.8	1.8	1.8
Associate income	(91.0)	(75.0)	(57.6)	(60.4)	(64.8)	Net dividend yield (%)	4.0	3.3	1.2	1.2	3.3
Tax	2.0	1.0	3.0	0	0	Gross dividend yield (%)	3.4	3.4	3.5	3.6	4.0
Depreciation capex adj	(91.0)	(73.0)	(49.1)	(70.6)	(76.2)		4.7	4.8	4.9	5.0	5.6
Adjusted normalised NPAT	57.6	77.8	63.0	89.5	89.1						
Abnormals/other	255.6	239.0	229.5	263.8	278.0						
Reported NPAT	(6.6)	118.0	(70.0)	(89.5)	(89.1)						
Normalised EPS (cps)	249.0	357.0	159.5	174.3	188.8						
DPS (cps)	18.8	17.6	16.9	19.4	20.4						
	15.1	15.5	15.8	16.2	18.1						
Growth Rates						Capital Structure					
Revenue (%)	2018A	2019A	2020A	2021A	2022A	Interest cover EBIT (x)	2018A	2019A	2020E	2021E	2022E
EBITDA (%)	12.6	11.2	-16.1	-1.1	1.4	Interest cover EBITDA (x)	4.7	6.7	4.6	5.1	5.1
EBIT (%)	8.2	-10.8	-2.4	4.4	5.4	Net debt/ND+E (%)	6.2	6.7	8.5	8.5	8.4
Normalised NPAT (%)	7.9	-17.7	-4.5	5.9	8.1	Net debt/EBITDA (x)	70.8	61.8	66.3	70.2	71.9
Normalised EPS (%)	1.8	-6.5	-4.0	14.9	5.4		2.2	2.2	2.5	2.7	2.6
Ordinary DPS (%)	2.9	-6.4	-4.0	14.9	5.4						
	3.4	2.6	1.9	2.5	11.7						
Cash Flow (NZ\$m)						Key Ratios					
EBITDA	2018A	2019A	2020E	2021E	2022E	Return on assets (%)	2018A	2019A	2020E	2021E	2022E
Working capital change	566.0	505.0	492.7	514.3	542.2	Return on equity (%)	7.1	7.8	4.1	4.6	5.0
Interest & tax paid	4.0	2.0	48.9	(32.4)	(18.4)	Return on funds employed (%)	6.0	4.6	4.8	5.1	5.6
Other	(192.0)	(148.0)	(149.5)	(150.9)	(161.2)	EBITDA margin (%)	5.8	4.7	4.4	4.6	5.0
Operating cash flow	(4.0)	(33.0)	(8.0)	0	0	EBIT margin (%)	31.5	25.3	29.4	31.0	32.2
Capital expenditure	374.0	326.0	384.1	331.0	362.6	Capex to sales (%)	20.4	15.1	17.2	18.4	19.6
(Acquisitions)/divestments	(127.0)	(122.0)	(308.0)	(254.9)	(161.4)	Capex to depreciation (%)	7.1	6.1	18.3	15.3	9.6
Other	(139.0)	215.0	0	0	0	Imputation (%)	69	67	168	136	85
Funding available/(required)	1.0	12.0	0.8	(2.5)	(2.7)	Pay-out ratio (%)	100	100	100	100	100
Dividends paid	109.0	431.0	77.0	73.6	198.5		80	88	94	84	89
Equity raised/(returned)	(273.0)	(208.0)	(214.1)	(216.4)	(224.5)						
(Increase)/decrease in net debt	(50.0)	0	0	0	0						
	(214.0)	223.0	(137.1)	(142.7)	(26.1)						
Balance Sheet (NZ\$m)						Operating Performance					
Working capital	2018A	2019A	2020E	2021E	2022E	Hydro	2018A	2019A	2020E	2021E	2022E
Fixed assets	63.0	63.0	19.1	51.5	69.9	Geothermal	4,947	4,006	3,823	4,016	4,016
Intangibles	5,370.0	5,528.0	5,636.7	5,686.2	5,639.0	Wind	2,757	2,894	2,815	2,841	2,841
Right of use asset	85.0	62.0	60.1	60.6	61.4	Total MCY Generation (GWh)	0	0	0	181	562
Other assets	0	0	0	0	0	GWAP (\$/MWh)	7,704	6,900	6,637	7,038	7,419
Total funds employed	385.0	521.0	516.2	518.6	521.4	Electricity sales	86	139	97	86	86
Net debt/(cash)	5,903.0	6,174.0	6,232.0	6,317.0	6,291.7	Electricity customers (000)	388	373	350	346	343
Lease liability	1,264.0	1,096.0	1,229.1	1,371.8	1,397.9	MM volumes	3,278	3,182	2,801	2,823	2,801
Other liabilities	0	0	0	0	0	TOU volumes	1,200	1,319	1,478	1,537	1,544
Shareholder's funds	1,306.0	1,498.0	1,482.5	1,466.8	1,451.2	Total Fixed Price volumes (GWh)	4,478	4,501	4,279	4,360	4,345
Minority interests	3,333.0	3,580.0	3,520.4	3,478.3	3,442.6	Spot Sales	891	780	729	732	736
Total funding sources	0	0	0	0	0	Net CFD's	2,110	1,665	1,881	2,069	2,069
	5,903.0	6,174.0	6,232.0	6,317.0	6,291.7	Total Sales (GWh)	7,479	6,946	6,888	7,161	7,150
						Average usage per cust (MWh/yr)	11.4	11.8	11.9	12.5	12.6
						LWAP (\$/MWh)	92	145	100	91	91
						LWAP/GWAP	1.06	1.04	1.03	1.05	1.06
						Average FPV price (\$/MWh)	113	113	117	120	121
						Line losses (%)	5.6	5.1	5.1	5.2	5.1
						Energy margin (\$m)	730	667	668	695	726
						Operating costs (\$m)	(205)	(199)	(192)	(200)	(205)
						Other revenue (\$m)	41	37	17	20	21
						MCY EBITDAF (\$m)	566	505	493	514	542

Forecast changes

Figure 2. Forecast changes

	FY20 Old \$m	FY20 New \$m	% Chg	FY21 Old \$m	FY21 New \$m	% Chg	FY22 Old \$m	FY22 New \$m	% Chg
Sales revenue	1,762	1,659	-6%	1,750	1,638	-6%	1,709	1,660	-3%
Cost of sales	(1,086)	(992)	-9%	(1,050)	(943)	-10%	(973)	(934)	-4%
Energy margin	676	668	-1%	700	695	-1%	736	726	-1%
Other income	17	17	0%	20	20	0%	21	21	0%
Other operating costs	(192)	(192)	0%	(194)	(200)	3%	(203)	(205)	1%
EBITDAF	501	493	-1.7%	526	514	-2.2%	554	542	-2.1%
Depn & amort	(207)	(207)	0%	(209)	(209)	0%	(212)	(212)	0%
FV mvmts, assoc inc, other	(19)	(19)	0%	-	-		4	3	-7%
EBIT	275	266	-3%	317	305	-4%	345	333	-3%
Net interest	(58)	(58)	0%	(60)	(60)	1%	(64)	(65)	1%
Pre-tax profit	217	209	-4%	257	245	-5%	281	269	-4%
Tax	(52)	(49)	-5%	(74)	(71)	-4%	(80)	(76)	-4%
NPAT	166	159	-4%	183	174	-5%	201	192	-4%
Normalised NPAT	173	167	-4%	183	174	-5%	198	189	-4%
Dividend (cps) (incl specials)	15.8	15.8	0%	16.2	16.2	0%	18.6	18.1	-3%
Operating statistics									
Generation (GWh)	6,697	6,637	-0.9%	7,040	7,038	0.0%	7,421	7,419	0.0%
FPVV sales (GWh)	4,370	4,279	-2.1%	4,363	4,360	-0.1%	4,347	4,345	-0.1%
Customer numbers (000)	352.4	349.9	-0.7%	348.9	346.5	-0.7%	345.4	343.0	-0.7%
GWAP (\$/MWh)	\$110.0	\$97.1	-11.7%	\$105.2	\$86.1	-18.2%	\$93.3	\$86.5	-7.3%
LWAP/GWAP	1.042	1.032	-0.9%	1.050	1.052	0.2%	1.056	1.056	0.0%

Source: Forsyth Barr analysis

Investment Summary

Our rating is OUTPERFORM. MCY is a strong operator in the sector with well-positioned generation assets. Whilst its near-term dividend yield is the lowest in the sector, we expect that to improve following the completion of its Turitea wind farm in 2021. It has the strongest dividend growth profile in the sector.

Business quality

- **Low risk, modest growth industry:** Electricity demand is relatively inelastic and is expected to grow slowly in the future. The industry is well positioned to benefit from New Zealand decarbonising transport and industrial processes.
- **Strong generation position:** The value within the electricity sector lies within the generation assets. MCY is the largest North Island generator and its hydro generation is suited to meeting electricity demand peaks.
- **Track record:** MCY has a strong development track record, having built a geothermal generation portfolio in the past 15 years and is expanding into wind.

Earnings and cashflow outlook

- **Earnings growth after FY21:** MCY's move into a development phase will drive earnings growth after FY21. The new wind farm development at Turitea is likely to add ~\$55m (~+11%) per annum to underlying EBITDAF.
- **Operating cash flow strong but development restarting:** MCY has a strong track record of returning surplus cash to shareholders; however, with new generation under development, capital returns above the ordinary dividend are less likely.

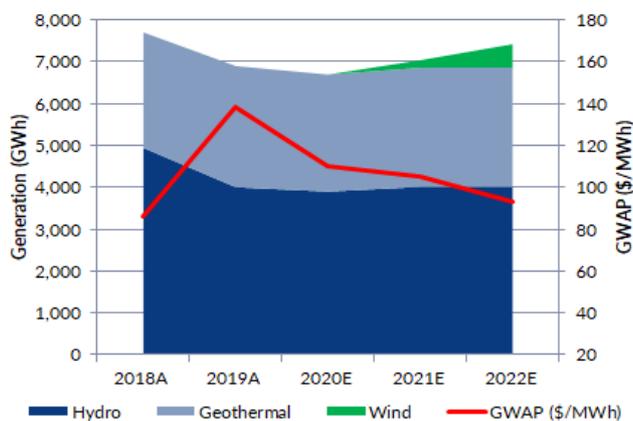
Financial structure

- **Balance sheet:** MCY's balance sheet has reasonable headroom (particularly after including treasury shares acquired in past buy-backs). Its Tilt Renewables investment and decision to build new generation means there is no surplus capital for the next few years.

Risk factors

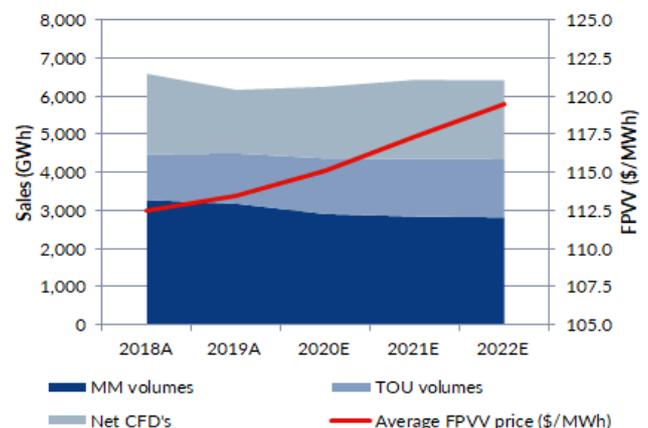
- **Political/regulatory:** The 2014 election and recent Electricity Price Review (EPR) highlighted the political/regulatory risks inherent in the sector. Whilst the EPR gave the sector a thumbs-up in most areas, the political risk is unlikely to ever disappear.
- **NZAS risk:** NZAS has indicated it is undertaking a strategic review, raising the possibility it may close. In our view, the smelter is unlikely to close (less than 10% chance), but if it did MCY would be one of the least affected generator/retailers.

Figure 3. Generation volumes and average price received



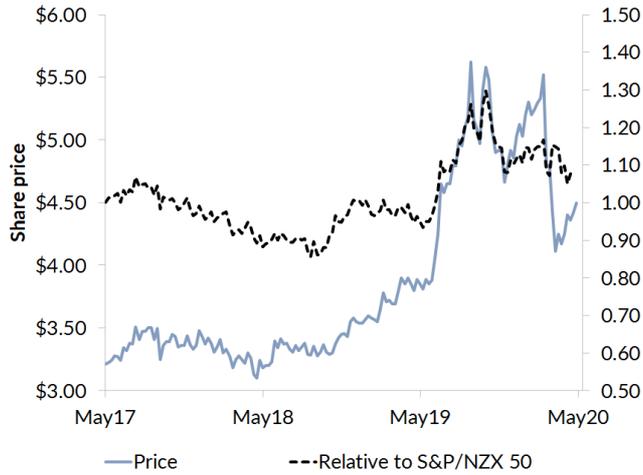
Source: MCY, Forsyth Barr analysis

Figure 4. Sales volumes and average price received



Source: MCY, Forsyth Barr analysis

Figure 5. Price performance



Source: Forsyth Barr analysis

Figure 6. Substantial shareholders

Shareholder	Latest Holding
NZ Govt	52.6%

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

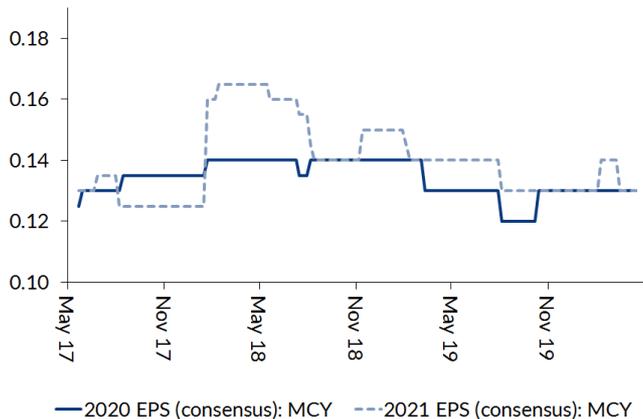
Figure 7. International valuation comparisons

Company	Code	Price	Mkt Cap (m)	PE		EV/EBITDA		EV/EBIT		Cash Yld
(metrics re-weighted to reflect MCY's balance date - June)										
				2020E	2021E	2020E	2021E	2020E	2021E	2021E
Mercury	MCY NZ	NZ\$4.50	NZ\$6,117	26.7x	23.2x	14.6x	14.0x	25.0x	23.6x	3.6%
Contact Energy*	CEN NZ	NZ\$6.30	NZ\$4,524	20.1x	18.5x	12.6x	11.8x	25.2x	22.8x	6.2%
Genesis Energy*	GNE NZ	NZ\$2.85	NZ\$2,957	18.7x	15.1x	11.7x	10.4x	31.6x	24.8x	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%
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%
Compcop Average:				18.0x	18.6x	10.8x	10.7x	20.0x	20.1x	5.3%
MCY Relative:				48%	25%	35%	31%	25%	18%	-32%

EV = Current Market Cap + Actual Net Debt

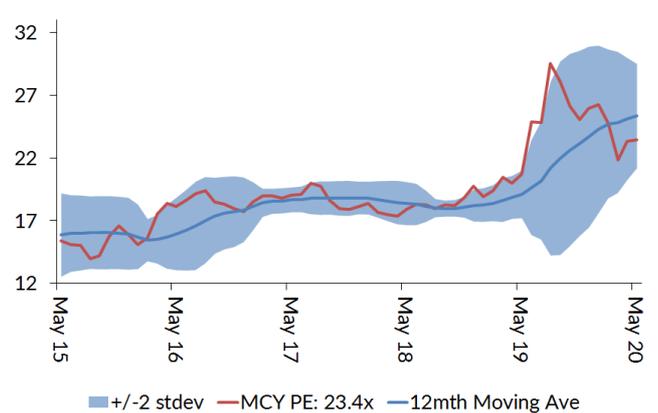
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compcop metrics re-weighted to reflect headline (MCY) companies fiscal year end

Figure 8. Consensus EPS momentum (NZ\$)



Source: Forsyth Barr analysis

Figure 9. One year forward PE (x)



Source: Forsyth Barr analysis

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OUTPERFORM	NEUTRAL	UNDERPERFORM
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