FORSYTH BARR

NEW ZEALAND EQUITY RESEARCH | UTILITIES | ELECTRICITY GENERATOR/RETAILER
19 AUGUST 2020

Mercury
Certain in Uncertain Times — FY20 Result

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NEUTRAL

Despite the smelter's closure causing significant sector earnings uncertainty, Mercury (MCY) has sent a strong message that it does not believe it will be greatly impacted. Not only has MCY provided FY21 dividend and earnings guidance, indicating it is confident of the near-term outlook, but it has increased its dividend guidance a material +7.6% to 17cps. We have lifted our target price +89cps (+20%) to NZ$5.30 with the better than expected FY21 earnings and dividend guidance, plus a lower cost of capital increasing our valuation metrics. However, with MCY trading at five month highs, we retain our NEUTRAL rating.

NZX Code	MCY
Share price	NZ$5.01
Target price	NZ$5.30
Risk rating	Low
Issued shares	1360.9m
Market cap	NZ$6,818m
Avg daily turnover	1,146k (NZ$5,536k)

Financials: Jun/	20A	21E	22E	23E
NPAT* (NZ$m)	236.1	271.3	246.9	238.3
EPS* (NZc)	17.3	19.9	18.1	17.5
EPS growth* (%)	-1.2	14.9	-9.0	-3.5
DPS (NZc)	15.8	17.0	17.0	18.0
Imputation (%)	100	100	90	80

*Based on normalised profits

Valuation (x)	20A	21E	22E	23E
EV/EBITDA	16.0	15.1	15.7	15.8
EV/EBIT	27.2	26.5	29.3	30.1
PE	28.9	25.1	27.6	28.6
Price / NTA	1.9	1.9	1.9	2.0
Cash div yld (%)	3.2	3.4	3.4	3.6
Gross div yld (%)	4.4	4.7	4.6	4.7

Dividend guidance sends strong signal that MCY does not believe it is materially impacted by NZAS closing

MCY's surprisingly strong 17cps FY21 dividend guidance is the main take-out from the FY20 result. It sends a strong market signal that it is confident in its earnings outlook despite NZAS causing significant sector earnings uncertainty. MCY wants to continue growing its dividend, building on its 12 years of consistent dividend growth — and at the worst, maintain its dividend, making the dividend increase even more meaningful. MCY is not immune to NZAS-related earnings uncertainty, but effects of closure on MCY are cushioned by the upcoming Turitea wind farm commissioning. Whilst we have lifted our FY21 dividend forecast in line with MCY's guidance, we are more cautious on the outlook.

FY20 result in line with expectations, but significant associate income creates some noise

MCY's reported FY20 EBITDAF of NZ$494m was +NZ$14m ahead of guidance and +NZ$11m ahead of our forecast. However, included in EBITDAF is an NZ$18m associate income gain and on a pre-associate income basis, MCY's FY20 EBITDAF was NZ$476m, vs, guidance of NZ$475m. The FY20 result was a good one. MCY's initial FY20 EBITDAF guidance of NZ$485m assumed normal hydrology. In reality hydro generation was ~-300GWh below average, so in that context the result was a strong one. A key driver of the improved performance was the +7% increase in fixed price electricity sales prices, mainly on commercial volumes. Despite EBITDAF coming in -6% lower than FY19, Normalised NPAT of NZ$164m was +NZ$3m higher than FY19. Interest costs fell -NZ$21m (-28%) due to high interest rate debt rolling off and was a significant factor in the uplift in the bottom line.

Significant target price uplift with cost of capital changes aiding forecast and dividend increases

MCY's FY21 EBITDAF guidance is NZ$515m (~NZ$509m before associate income), and assumes slightly below average hydrology and a +NZ$5m contribution from the Turitea wind farm in 2H21. We have lifted our (pre-associate income) EBITDAF forecast +NZ$11m (+2%) to NZ$510m. We have also increased our dividend +1.2cps to 17.0cps, consistent with MCY's guidance. The more positive earnings and dividend outlook, coupled with our cost of capital assumption falling -1.7% to 5.1%, has result in our weighted average valuation increasing +22% to NZ$5.13. We are retaining our NEUTRAL rating as MCY's near-term upside appears limited. MCY is trading higher than it was before the NZAS closure announcement, the only generator/retailer to achieve that distinction.

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Mercury NZ Limited (MCY)

Priced as at 18 Aug 2020 (NZ$)	5.01

12-month target price (NZ$)*	**5.30**
Expected share price return	5.8%
Net dividend yield	3.4%
Estimated 12-month return	9.2%

Key WACC assumptions	
Risk free rate	1.30%
Equity beta	0.84
WACC	5.1%
Terminal growth	1.5%

Profit and Loss Account (NZ$m)	2019A	2020A	2021E	2022E	2023E
Sales revenue	2,000.0	1,750.0	1,756.4	1,609.1	1,638.8
Normalised EBITDA	**505.0**	**476.0**	**510.0**	**494.8**	**491.4**
Depreciation and amortisation	(204.0)	(214.0)	(223.0)	(230.8)	(236.2)
Normalised EBIT	**301.0**	**262.0**	**286.9**	**264.0**	**255.3**
Net interest	(75.0)	(54.0)	(54.4)	(61.4)	(66.9)
Associate income	1.0	18.0	4.1	1.9	2.8
Tax	(73.0)	(41.0)	(68.2)	(59.2)	(55.5)
Depreciation capex adj	77.8	72.0	103.0	101.7	102.6
Adjusted normalised NPAT	**239.0**	**236.1**	**271.3**	**246.9**	**238.3**
Abnormals/other	118.0	(29.1)	(103.0)	(101.7)	(102.6)
Reported NPAT	**357.0**	**207.0**	**168.3**	**145.2**	**135.7**
Normalised EPS (cps)	17.6	17.3	19.9	18.1	17.5
DPS (cps)	15.5	15.8	17.0	17.0	18.0

Growth Rates	2019A	2020A	2021A	2022A	2023A
Revenue (%)	11.2	-12.5	0.4	-8.4	1.8
EBITDA (%)	-10.8	-5.7	7.1	-3.0	-0.7
EBIT (%)	-17.7	-7.3	3.9	-8.6	-2.9
Normalised NPAT (%)	-6.5	-1.2	14.9	-9.0	-3.5
Normalised EPS (%)	-6.4	-1.2	14.9	-9.0	-3.5
Ordinary DPS (%)	2.6	1.9	7.6	0.0	5.9

Cash Flow (NZ$m)	2019A	2020A	2021E	2022E	2023E
EBITDA	**505.0**	**476.0**	**510.0**	**494.8**	**491.4**
Working capital change	2.0	92.0	(33.8)	(31.2)	(6.9)
Interest & tax paid	(148.0)	(136.0)	(151.5)	(144.6)	(142.4)
Other	2.0	(76.0)	0	0	0
Operating cash flow	**361.0**	**356.0**	**324.6**	**319.0**	**342.2**
Capital expenditure	(122.0)	(223.0)	(250.2)	(162.3)	(93.6)
(Acquisitions)/divestments	215.0	0	54.5	0	0
Other	12.0	4.0	(2.4)	(2.6)	(1.5)
Funding available/(required)	**466.0**	**137.0**	**126.6**	**154.1**	**247.0**
Dividends paid	(208.0)	(214.0)	(220.5)	(231.4)	(235.4)
Equity raised/(returned)	0	0	0	0	0
(Increase)/decrease in net debt	**258.0**	**(77.0)**	**(93.9)**	**(77.2)**	**11.6**

Balance Sheet (NZ$m)	2019A	2020A	2021E	2022E	2023E
Working capital	63.0	(14.0)	19.8	51.0	57.9
Fixed assets	5,528.0	5,898.0	5,935.3	5,872.5	5,730.9
Intangibles	62.0	55.0	50.9	48.8	48.0
Right of use asset	0	0	0	0	0
Other assets	521.0	587.0	538.9	543.4	547.7
Total funds employed	**6,174.0**	**6,526.0**	**6,544.9**	**6,515.7**	**6,384.6**
Net debt/(cash)	1,096.0	1,149.0	1,242.9	1,320.1	1,308.5
Lease liability	0	0	0	0	0
Other liabilities	1,498.0	1,575.0	1,552.1	1,531.8	1,512.1
Shareholder's funds	3,580.0	3,802.0	3,749.9	3,663.7	3,563.9
Minority interests	0	0	0	0	0
Total funding sources	**6,174.0**	**6,526.0**	**6,544.9**	**6,515.7**	**6,384.6**

Spot valuations (NZ$)	
1. DCF	5.09
2. Market multiple	5.19
3. Dividend yield	5.14

DCF valuation summary (NZ$m)	
Total firm value	8,071
(Net debt)/cash	(1,149)
Less: Capitalised operating leases	
Value of equity	6,922

Valuation Ratios	2019A	2020A	2021E	2022E	2023E
EV/EBITDA (x)	15.3	16.0	15.1	15.7	15.8
EV/EBIT (x)	25.6	27.2	26.5	29.3	30.1
PE (x)	28.5	28.9	25.1	27.6	28.6
Price/NTA (x)	2.0	1.9	1.9	1.9	2.0
Free cash flow yield (%)	3.5	2.0	1.1	2.3	3.6
Net dividend yield (%)	3.1	3.2	3.4	3.4	3.6
Gross dividend yield (%)	4.3	4.4	4.7	4.6	4.7

Capital Structure	2019A	2020A	2021E	2022E	2023E
Interest cover EBIT (x)	6.7	5.6	5.3	4.3	3.9
Interest cover EBITDA (x)	6.7	8.8	9.4	8.1	7.3
Net debt/ND+E (%)	61.8	63.2	66.8	71.3	75.2
Net debt/EBITDA (x)	2.2	2.4	2.4	2.7	2.7

Key Ratios	2019A	2020A	2021E	2022E	2023E
Return on assets (%)	7.8	4.4	4.3	3.9	3.9
Return on equity (%)	4.6	4.4	4.6	4.0	3.9
Return on funds employed (%)	4.7	3.9	4.2	3.9	3.8
EBITDA margin (%)	25.3	27.2	29.0	30.7	30.0
EBIT margin (%)	15.1	16.0	16.6	16.5	15.7
Capex to sales (%)	6.1	12.7	14.2	10.1	5.7
Capex to depreciation (%)	67	120	127	79	44
Imputation (%)	100	100	100	90	80
Pay-out ratio (%)	88	91	85	94	103

Operating Performance	2019A	2020A	2021E	2022E	2023E
Hydro	4,006	3,708	3,924	4,016	4,016
Geothermal	2,894	2,812	2,841	2,841	2,841
Wind	0	0	77	543	838
Total MCY Generation (GWh)	**6,900**	**6,520**	**6,842**	**7,399**	**7,695**
GWAP ($/MWh)	139	110	104	74	73
Electricity sales					
Electricity customers (000)	373	348	343	349	356
MM volumes	3,182	2,892	2,778	2,799	2,857
TOU volumes	1,319	1,469	1,602	1,750	1,894
Total Fixed Price volumes (GWh)	**4,501**	**4,361**	**4,380**	**4,549**	**4,751**
Spot Sales	780	746	750	753	757
Net CFD's	1,665	1,289	1,524	1,524	1,524
Total Sales (GWh)	**6,946**	**6,396**	**6,653**	**6,826**	**7,032**
Average usage per cust (MWh/yr)	11.8	12.2	12.7	13.1	13.5
LWAP ($/MWh)	145	115	109	78	78
LWAP/GWAP	1.04	1.05	1.05	1.05	1.06
Average FPVV price ($/MWh)	113	118	119	113	111
Line losses (%)	5.1	4.9	5.2	5.1	5.2
Energy margin ($m)	667	652	687	676	675
Operating costs ($m)	(199)	(190)	(192)	(195)	(199)
Other revenue ($m)	37	14	14	14	15
MCY EBITDAF ($m)	**505**	**476**	**510**	**495**	**491**

Forecast and target price changes

MCY's FY21 EBITDAF guidance is NZ$515m (incl ~NZ$6m of associate income, i.e. NZ$509m pre-associate income) and FY21 dividend guidance is 17cps (fully imputed). Both of these guided figures are significantly better than we had been forecasting.

Key changes to our forecasts include:

- Increasing our dividend forecast +1.2cps to 17.0cps. We had assumed MCY would keep its dividend flat given the uncertain NZAS outlook. Whilst MCY is not directly impacted by NZAS closing, it is not immune. New commercial and industrial contracts will be factoring in lower wholesale electricity price expectations, there is likely to be some retail price pressure and MCY's Turitea wind farm will be receiving less for its electricity than originally expected. MCY's decision to lift its dividend materially (the biggest increase since FY14 when Ngatamariki commissioning lifted earnings) is certainly eye-catching.
- Lower forecast operating costs as increased focus goes on costs.
- Reduced Turitea wind generation volumes. MCY has indicated that the wind farm commissioning date has been delayed, due mainly to COVID-19 impacts in April/May 2020.
- Lift in deprecation due to increased amortisation of intangible assets and an +NZ$296m asset revaluation increase.
- Whilst it is not a change, it is worth noting the MCY's FY22 and beyond dividend is not expected to be fully imputed due to the commissioning of Turitea, increasing tax deprecation and accordingly, reducing tax payments.

Figure 1. Forecast changes

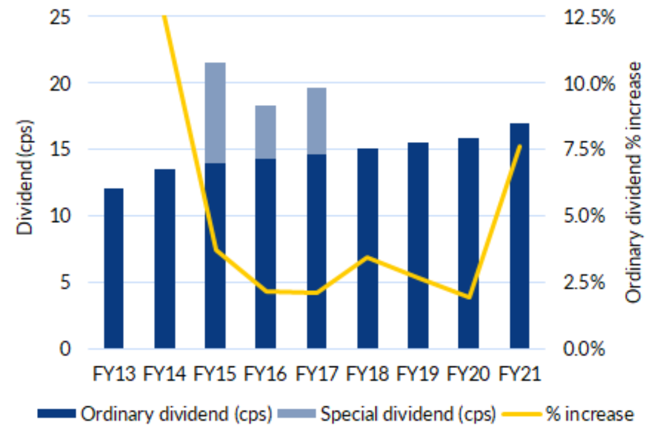
NZ$m	FY21 Old	FY21 New	% Chg	FY22 Old	FY22 New	% Chg	FY23 Old	FY23 New	% Chg
Sales revenue	1,739	1,740	0%	1,596	1,593	0%	1,639	1,622	-1%
Cost of sales	(1,060)	(1,053)	-1%	(933)	(917)	-2%	(972)	(947)	-3%
Energy margin	**679**	**687**	**1%**	**663**	**676**	**2%**	**667**	**675**	**1%**
Other net income	20	14	-30%	21	14	-30%	21	15	-30%
Other operating costs	(200)	(192)	-4%	(205)	(195)	-5%	(208)	(199)	-5%
EBITDAF (pre-assoc income)	**499**	**510**	**2%**	**479**	**495**	**3%**	**480**	**491**	**2%**
Depn & amort	(209)	(223)	7%	(212)	(231)	9%	(219)	(236)	8%
FV mvmts, assoc inc, other	(3)	4		(6)	9		(2)	3	
EBIT	**287**	**291**	**1%**	**261**	**273**	**5%**	**260**	**258**	**-1%**
Net interest	(59)	(54)	-8%	(63)	(61)	-2%	(67)	(67)	-1%
Pre-tax profit	**228**	**237**	**4%**	**198**	**212**	**7%**	**192**	**191**	**-1%**
Tax	(66)	(68)	4%	(59)	(59)	1%	(56)	(56)	-1%
NPAT	**162**	**168**	**4%**	**139**	**152**	**9%**	**137**	**136**	**-1%**
Normalised NPAT	**162**	**168**	**4%**	**144**	**145**	**1%**	**137**	**136**	**-1%**
Dividend (cps)	15.8	17.0	8%	15.8	17.0	8%	17.8	18.0	1%
Operating statistics			Diff			Diff			Diff
Generation (GWh)	6,946	6,842	-1.5%	7,419	7,399	-0.3%	7,695	7,695	0.0%
FPVV sales (GWh)	4,390	4,380	-0.2%	4,559	4,549	-0.2%	4,761	4,751	-0.2%
Customer numbers (000)	340.8	342.8	0.6%	347.5	349.5	0.6%	353.6	355.6	0.6%
GWAP ($/MWh)	$105.7	$103.8	-1.8%	$77.7	$74.3	-4.5%	$78.4	$73.2	-6.7%
LWAP/GWAP	1.048	1.048	0.0%	1.056	1.052	-0.3%	1.060	1.062	0.2%

Source: Forsyth Barr analysis

Valuation and target price changes

We have increased our target price +89cps (+20%) to NZ$5.30/share. The main driver of the significant uplift has been the cost of capital changes we have made, with MCY's cost of capital falling -1.7% to 5.1% (from 6.8%). Electricity stocks are material beneficiaries of the cost of capital changes. In addition, the uplift in our forecast and dividend has also aided the target price increase, however, the impact of lifting near-term earnings and dividend on our market multiple and dividend yield valuations is a more modest +7% to +8%.

Figure 2. Historic MCY dividend



Source: MCY, Forsyth Barr analysis

Figure 3. Valuation and target price changes

	Old valuation	New valuation	% chg	NZ$ chg
DCF (40%)	$3.34	$5.09	52%	$1.75
Market multiple (20%)	$4.85	$5.19	7%	$0.34
Dividend yield (40%)	$4.77	$5.14	8%	$0.37
Weighted average	**$4.21**	**$5.13**	**22%**	**$0.91**
Target price	**$4.41**	**$5.30**	**20%**	**$0.89**

Source: Forsyth Barr analysis

FY20 result summary analysis

Figure 4. FY20 result summary analysis

	FY19 NZ$m	FY20 NZ$m	% Chg	FB NZ$m	Diff $m	Commentary
Sales revenue	1,957	1,734	-11%	1,729	5	Decline due to lower generation and lower wholesale electricty prices vs. pcp
Cost of sales	(1,290)	(1,082)	16%	(1,073)	(9)	
Energy margin	**667**	**652**	**-2%**	**656**	**(4)**	Largely due to the drought causing low hydro generation, offset by price increases
Net other revenue	37	14	-62%	19	(5)	Decline due to sale of Metric business
Other operating costs	(199)	(190)	5%	(192)	2	In line with FY19 after normalising for IFRS 16 changes and Metrix divestment
EBITDAF	**505**	**476**	**-6%**	**483**	**(7)**	Reported EBITDAF of NZ$494m includes NZ$18m "bargain purchase gain" on TLT
Depn & amort	(204)	(214)	-5%	(207)	(7)	
FV mvmts, assoc inc, other	204	40	-80%	(15)	55	FY19 was elevated due to NZ$177m sale of Metrix
EBIT	**505**	**302**	**-40%**	**260**	**42**	
Net interest	(75)	(54)	28%	(58)	4	Interest costs down due to high cost debt rolling off
Pre-tax profit	430	248	-42%	203	45	
Tax	(73)	(41)	44%	(48)	7	
NPAT	**357**	**207**	**-42%**	**155**	**52**	
Normalised NPAT	**161**	**164**	**2%**	**162**	2	Normalised for Metrix divestment (FY19), fair value mvmts & TLT gain (FY20)
EPS (cps)	11.9	12.1	2%	11.9	0.1	
FY dividend (cps)	15.5	15.8	2%	15.8	0.0	In line with guidance
Final dividend (cps)	9.3	9.4	1%	9.3	0.1	
Operating statistics						
Generation (GWh)	6,900	6,520	-6%	6,520	0.0	Largely due to hydro generation down -294GWh (-7.3%)
FPVV sales (GWh)	4,501	4,361	-3%	4,361	0.0	
Customer numbers	373,000	348,000	-7%	348,000	0.0	~-8,000 due to Farm Source exit, as well as consistent losses to switching
GWAP ($/MWh)	$138.7	$109.5	-21%	$109.5	0.0	
LWAP/GWAP	1.04	1.05	0%	1.05	0.0	

Source: MCY, Forsyth Barr analysis

Other points to note:

- MCY has reported associate income within EBITDAF, we have reported it after EBITDAF. In FY19 associate income totalled NZ$1m, vs. NZ$18m in FY20, due to a significant "bargain purchase" gain. MCY had included ~NZ$5m of associate income in its FY20 EBITDAF guidance of NZ$480m, hence, the pre-associate EBITDAF result of NZ$476m is +NZ$1m ahead of MCY guidance.
- MCY's 20% holding in Tilt Renewables (TLT) has been treated as an associate from 19 July 2019 when MCY gained a board seat.
- In its post-balance date event note, (Note 19) MCY indicates that if the NZAS announcement had taken place before 30 June, the asset revaluation would have been +NZ$42m instead of the actual +NZ$296m i.e. still an increase. This highlights MCY does not believe NZAS closing will have a material impact on its business. The NZ$254m valuation difference equates to 4.3% of MCY's fixed asset value.

Investment Summary

Our rating is NEUTRAL. MCY is a strong operator in the sector with well-positioned generation assets. The closure of NZAS has no direct impact on MCY, but it will be affected by lower retail prices. MCY offers a secure dividend that we do not expect will be cut, however, we see limited/no dividend growth for the next few years as the electricity market adjusts to life without NZAS.

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 limited following NZAS closure:** The gains we had been expecting from the completion of its Turitea wind farm we estimate will be offset by lower retail prices.
- **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.

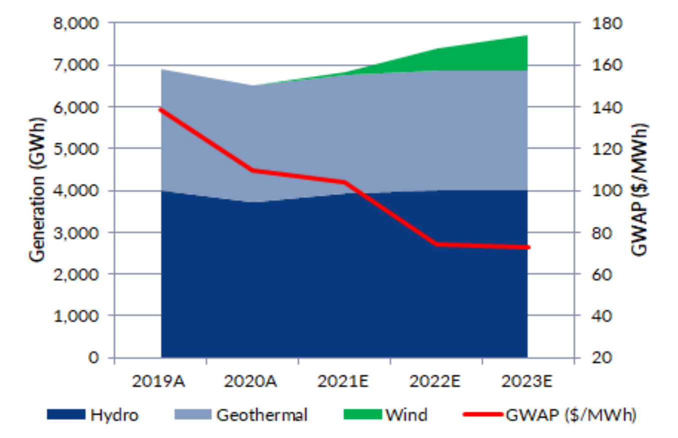
Financial structure

- **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

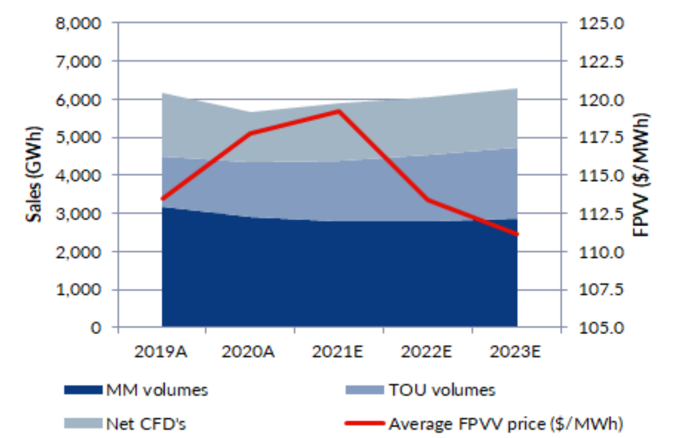
- **Political/regulatory:** The 2014 election and recent Electricity Price Review (EPR) highlighted the political/regulatory risks inherent in the sector. Whilst the EPR gave the sector a thumbs-up in most areas, the political risk is unlikely to ever disappear.
- **NZAS closure:** Rio Tinto (RIO) has announced it intends to shutter the Tiwai Point aluminum smelter NZAS in August 2021. The main risk for MCY is increased retail competition, lowering retail prices further than anticipated.

Figure 5. Generation volumes and average price received



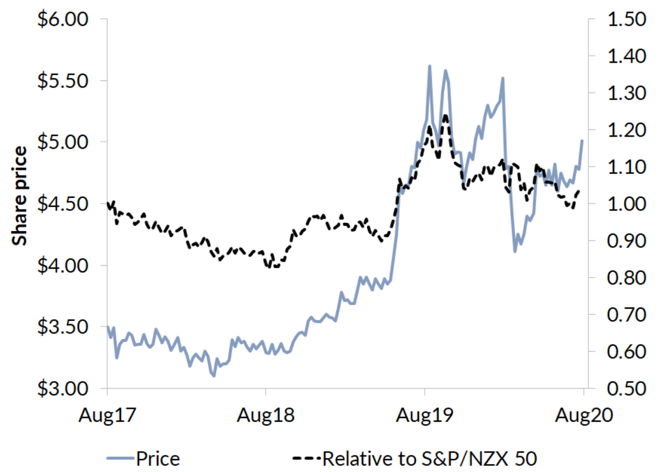
Source: MCY, Forsyth Barr analysis

Figure 6. Sales volumes and average price received



Source: MCY, Forsyth Barr analysis

Figure 7. Price performance



Source: Forsyth Barr analysis

Figure 8. Substantial shareholders

Shareholder	Latest Holding
NZ Govt	52.6%

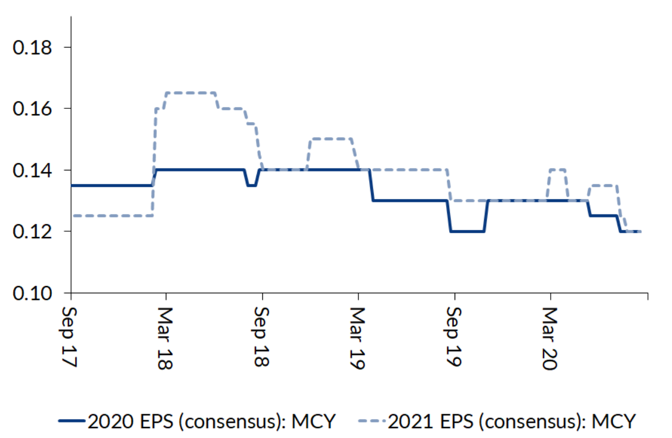
Source: NZX, Forsyth Barr analysis, NOTE: based on SPH notices only

Figure 9. International valuation comparisons

Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash Yld
(metrics re-weighted to reflect MCY's balance date - June)			(m)	2021E	2022E	2021E	2022E	2021E	2022E	2022E
Mercury	**MCY NZ**	**NZ$5.01**	**NZ$6,818**	**25.1x**	**27.6x**	**15.6x**	**16.1x**	**27.4x**	**30.0x**	**3.4%**
CONTACT ENERGY *	CEN NZ	NZ$6.34	NZ$4,553	19.9x	22.7x	12.8x	14.0x	30.3x	33.0x	5.0%
GENESIS ENERGY *	GNE NZ	NZ$2.82	NZ$2,920	19.0x	16.4x	11.8x	11.0x	32.8x	27.6x	5.0%
MERIDIAN ENERGY *	MEL NZ	NZ$4.71	NZ$12,057	24.2x	27.1x	15.7x	16.9x	24.7x	27.7x	3.5%
TRUSTPOWER *	TPW NZ	NZ$6.70	NZ$2,097	23.9x	24.1x	14.3x	14.4x	19.0x	19.2x	4.5%
AGL ENERGY	AGL AT	A$15.44	A$9,621	15.3x	18.0x	6.8x	7.6x	11.9x	14.3x	5.3%
ORIGIN ENERGY	ORG AT	A$5.82	A$10,250	10.2x	19.9x	5.3x	6.6x	13.3x	20.4x	3.4%
			Compco Average:	**18.7x**	**21.4x**	**11.1x**	**11.8x**	**22.0x**	**23.7x**	**4.4%**
EV = Current Market Cap + Actual Net Debt			**MCY Relative:**	**34%**	**29%**	**41%**	**37%**	**25%**	**26%**	**-24%**

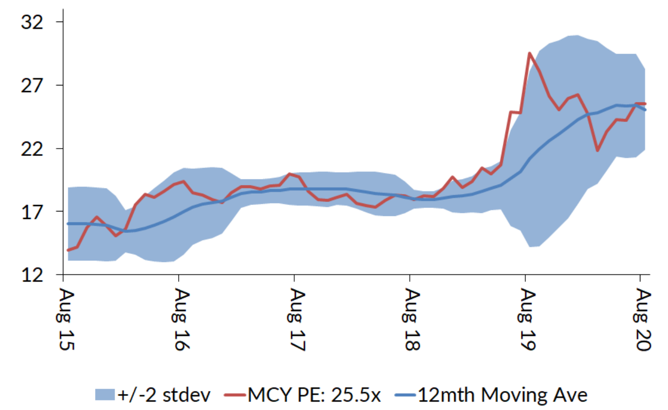
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (MCY) companies fiscal year end

Figure 10. Consensus EPS momentum (NZ$)



Source: Forsyth Barr analysis

Figure 11. One year forward PE (x)



Source: Forsyth Barr analysis

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