FORSYTH BARR

NEW ZEALAND EQUITY RESEARCH | UTILITIES | ELECTRICITY GENERATOR/RETAILER

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Trustpower
Mild COVID-19 Symptoms

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OUTPERFORM

Like all the electricity companies, we do not expect a material impact on Trustpower's (TPW) earnings from COVID-19. Whilst electricity demand is likely to be a little lower, that appears to be getting close to normal, with an increase in bad debts a bigger concern. We have trimmed our FY21 EBITDAF forecast -2.2%, but with investors expected to focus on defensive income in the coming months we are retaining our OUTPERFORM rating.

Figure 1. What's changed

FY20/FY21 EBITDAF:	FY20 EBITDAF unchanged at $187m, FY21 EBITDAF -$4m (-2.2%) to $203m
Target price:	Increased +5cps (+0.6%) to $7.75

NZX Code	TPW
Share price	NZ$6.61
Target price	NZ$7.75
Risk rating	Low
Issued shares	313.0m
Market cap	NZ$2,069m
Avg daily turnover	57.1k (NZ$414k)

Financials: Mar/	19A	20E	21E	22E
NPAT* (NZ$m)	116.6	84.0	97.2	103.5
EPS* (NZc)	37.1	26.8	31.0	32.9
EPS growth* (%)	-17.3	-27.9	15.7	6.4
DPS (NZc)	74.0	34.0	34.0	34.0
Imputation (%)	55	100	100	100
*Based on normalised profits				

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	11.7	14.4	13.5	12.9
EV/EBIT	14.8	18.3	16.8	15.9
PE	17.8	24.7	21.3	20.1
Price / NTA	1.7	1.9	1.9	1.9
Cash div yld (%)	11.2	5.1	5.1	5.1
Gross div yld (%)	13.6	7.1	7.1	7.1

FY20 result will be below average after two strong years

We are forecasting an FY20 EBITDAF of $187m, in the lower half of TPW's $185m to $195m guidance range, -16% lower than the pcp. FY20 has had its challenges, with lower hydro volumes a key factor. The competitive retail market has also had an impact on earnings, although we expect the telco segment to again be a positive highlight. Whilst we are not forecasting TPW to trim its dividend (typically electricity companies look through soft short-term earnings periods), the below average FY20 result coupled with COVID-19 uncertainties and a slightly stretched balance sheet may see TPW take a more conservative approach. TPW's FY20 result will be reported on Wednesday 27 May.

FY21 outlook tempered on modest COVID-19 effects

We have trimmed our FY21 EBITDAF forecast -$4m to $203m due to lower electricity sales volumes (down -2.3%), a modest increase in bad debts and the lower wholesale electricity price outlook (down -8.6%).

Expected investor focus on yield to provide share price support for TPW

Whilst our near-term earnings outlook is 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 (-0.15% to 5.75%) and lifted our target multiples modestly (adjusted PE up 0.5x to 24x), which has the effect of offsetting our modest earnings cuts.

Trustpower Ltd (TPW)

Priced as at 06 May 2020 (NZ$)	**6.61**

12-month target price (NZ$)*	**7.75**
Expected share price return	17.2%
Net dividend yield	5.1%
Estimated 12-month return	22.4%

Key WACC assumptions	
Risk free rate	2.00%
Equity beta	0.88
WACC	6.7%
Terminal growth	1.5%

Profit and Loss Account (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Sales revenue	979.4	1,030.1	975.7	937.3	973.3
Normalised EBITDA	**269.8**	**222.2**	**186.9**	**202.8**	**212.7**
Depreciation and amortisation	(15.8)	(47.2)	(39.5)	(39.8)	(40.3)
Normalised EBIT	**223**	**175**	**147**	**163**	**172**
Net interest	(34)	(28)	(35)	(36)	(37)
Depreciation capex adjustment	8	19	9	11	11
Tax	(55)	(48)	(35)	(40)	(42)
Minority interests	(1)	(2)	(2)	(2)	(2)
Normalised NPAT	**141**	**117**	**84**	**97**	**103**
Abnormals/other/depn adj	(13)	(26)	(17)	(8)	(8)
Reported NPAT	**128**	**91**	**67**	**89**	**95**
Normalised EPS (cps)	44.9	37.1	26.8	31.0	32.9
DPS (cps)	34.0	74.0	34.0	34.0	34.0

Growth Rates	**2018A**	**2019A**	**2020A**	**2021A**	**2022A**
Revenue (%)	4.2	5.2	-5.3	-3.9	3.8
EBITDA (%)	15.0	-17.6	-15.9	8.5	4.9
EBIT (%)	19.3	-21.6	-15.7	10.5	5.8
Normalised NPAT (%)	8.5	-17.3	-27.9	15.7	6.4
Normalised EPS (%)	8.5	-17.3	-27.9	15.7	6.4
Ordinary DPS (%)	3.0	0.0	0.0	0.0	0.0

Cash Flow (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EBITDA	**269.8**	**222.2**	**186.9**	**202.8**	**212.7**
Working capital change	24.6	(47.1)	(42.6)	0.7	9.1
Interest & tax paid	(63.8)	(74.8)	(79.0)	(71.5)	(75.6)
Other	(22.8)	20.0	20.4	0	0
Operating cash flow	**207.7**	**120.3**	**85.7**	**132.0**	**146.3**
Capital expenditure	(41.5)	(31.1)	(30.5)	(28.4)	(29.0)
(Acquisitions)/divestments	118.2	8.1	0	0	0
Other	3.9	(1.7)	0	0	0
Funding available/(required)	**288.2**	**95.6**	**55.1**	**103.6**	**117.3**
Dividends paid	(110.2)	(190.4)	(153.7)	(106.4)	(106.4)
Equity raised/(returned)	(0.5)	0	0	0	0
(Increase)/decrease in net debt	**177.6**	**(94.8)**	**(98.5)**	**(2.8)**	**10.9**

Balance Sheet (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Working capital	(28.3)	(0.3)	20.5	23.3	25.3
Fixed assets	2,102.2	1,924.7	1,913.0	1,898.6	1,884.2
Intangibles	44.1	37.0	40.1	43.2	46.2
Right of use asset	0	0	0	0	0
Other assets	59.6	114.8	178.3	174.7	163.7
Total funds employed	**2,177.6**	**2,076.2**	**2,151.9**	**2,139.8**	**2,119.3**
Net debt/(cash)	466.7	557.4	659.2	662.0	651.1
Lease liability	0	0	0	0	0
Other liabilities	275.9	269.8	314.1	314.9	314.9
Shareholder's funds	1,412.9	1,224.4	1,153.6	1,136.2	1,125.0
Minority interests	22.0	24.6	25.0	26.6	28.3
Total funding sources	**2,177.6**	**2,076.2**	**2,151.9**	**2,139.8**	**2,119.3**

Spot valuations (NZ$)	
1. DCF	7.21
2. Market multiples	7.39
3. Dividend Yield	8.14

DCF valuation summary (NZ$m)	
Total firm value	2,982
(Net debt)/cash	(687)
Less: Capitalised operating leases	
Value of equity	2,279

Valuation Ratios	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EV/EBITDA (x)	9.8	11.7	14.4	13.5	12.9
EV/EBIT (x)	11.9	14.8	18.3	16.8	15.9
PE (x)	14.7	17.8	24.7	21.3	20.1
Price/NTA (x)	1.5	1.7	1.9	1.9	1.9
Free cash flow yield (%)	8.0	4.3	2.7	5.0	5.7
Net dividend yield (%)	5.1	11.2	5.1	5.1	5.1
Gross dividend yield (%)	7.1	13.6	7.1	7.1	7.1

Capital Structure	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Interest cover EBIT (x)	7.0	6.8	4.5	4.8	5.0
Interest cover EBITDA (x)	7.9	7.9	5.4	5.6	5.8
Net debt/ND+E (%)	48.9	58.6	68.2	69.5	70.0
Net debt/EBITDA (x)	1.7	2.5	3.5	3.3	3.1

Key Ratios	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Return on assets (%)	9.2	7.2	5.9	7.3	7.8
Return on equity (%)	9.9	9.7	7.6	8.9	9.6
Return on funds employed (%)	8.5	7.2	5.9	6.4	6.8
EBITDA margin (%)	27.5	21.6	19.2	21.6	21.9
EBIT margin (%)	22.8	17.0	15.1	17.4	17.7
Capex to sales (%)	4.2	3.0	3.1	3.0	3.0
Capex to depreciation (%)	n/a	98	104	97	99
Imputation (%)	100	55	100	100	100
Pay-out ratio (%)	76	199	127	110	103

Operating Performance	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
NZ electricity revenue	810	861	803	765	793
Gas revenue	29	29	30	33	34
Telecommunication revenue	81	88	92	95	103
Other revenue	60	52	50	45	44
Total revenue	**979**	**1,030**	**976**	**937**	**973**
Generation (GWh)	2,235	1,995	1,758	1,896	1,896
NZ GWAP ($/MWh)	88	125	107	73	77
Mass market sales (GWh)	1,887	1,845	1,817	1,791	1,802
TOU sales (GWh)	842	880	826	807	828
Spot sales (GWh)	1,086	1,021	972	946	974
Total Sales (GWh)	**3,815**	**3,746**	**3,615**	**3,544**	**3,605**
LWAP ($/MWh)	91	131	109	79	83
LWAP/GWAP	1.04	1.04	1.01	1.08	1.07
Electricity customers (000)	273	267	266	265	263
Usage/customer (MWh)	6.9	6.8	6.8	6.8	6.8
Revenue/MWh sold ($)	212	230	222	216	220
Gas customers (000)	37	39	41	42	43
Volume/customer (GJ)	27.5	26.5	24.8	24.8	24.8
Telco customers (000)	87	96	104	111	116
Revenue/customer ($)	991	963	959	968	978

FY20 forecast

Figure 2. FY20 forecast

Year ending 31 March ($m)	FY19	FY20	Change
Electricity	861	803	-7%
Other	169	172	2%
Total Revenue	**1,030**	**976**	**-5%**
Costs	(808)	(789)	-2%
EBITDAF	**222**	**187**	**-16%**
Depreciation and amortisation	(47)	(39)	-16%
EBIT	**175**	**147**	**-16%**
Fair Value Gains/(Losses)	(6)	(12)	
One-off items	(11)	(2)	
Net interest	(28)	(35)	
Pretax Profit	**130**	**98**	**-25%**
Tax	(38)	(29)	-22%
REPORTED PROFIT	**93**	**69**	**-26%**
Minority interests	(2)	(2)	
Profit Attributable to Shareholders	**91**	**67**	**-26%**
Abnormal items	12	11	
NORMALISED PROFIT	**103**	**78**	**-24%**
Earnings per share (cps)	32.8	24.8	-24%
Final ordinary dividend	17.0	17.0	
Dividend per share (cps)	34.0	34.0	0%

Source: TPW, Forsyth Barr analysis

Summary forecast changes

Figure 3. Summary forecast changes

	FY20 Old $m	FY20 New $m	Chg %	FY21 Old $m	FY21 New $m	Chg %	FY22 Old $m	FY22 New $m	Chg %
Revenue	983	976	-0.7%	988	937	-5.2%	994	973	-2.1%
EBITDAF	**187**	**187**	**0.0%**	**207**	**203**	**-2.2%**	**217**	**213**	**-2.2%**
EBIT	145	145	0.0%	168	163	-2.8%	177	172	-2.6%
NPAT	**69**	**69**	**-0.1%**	**94**	**91**	**-3.9%**	**101**	**97**	**-3.8%**
Normalised Profit	78	78	-0.1%	93	89	-3.9%	99	95	-3.8%
DPS	34.0	34.0	0.0%	34.0	34.0	0.0%	35.0	34.0	-2.9%
Generation volumes (GWh)	1,753	1,758	0.3%	1,896	1,896	0.0%	1,896	1,896	0.0%
Electricity Wholesale Price ($/MWh)	$102.3	$81.1	-20.7%	$88.6	$81.0	-8.6%	$89.3	$77.4	-13.3%
Retail sales (GWh)	2,660	2,643	-0.6%	2,659	2,598	-2.3%	2,653	2,631	-0.9%

Source: Forsyth Barr analysis

Investment Summary

Our rating is OUTPERFORM. TPW is trading on undemanding multiples and offers investors an attractive dividend in a sector with stable earnings. The long-term outlook for the sector is positive as New Zealand looks to de-carbonise which will result in higher electricity use.

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.
- **Diversified generation position:** Most of the value within the electricity sector lies within the generation assets. TPW has several small scale hydro generators positioned around New Zealand, creating hydro diversification.
- **Track record:** TPW has focussed on developing a bundled retail strategy, offering telco products alongside its energy products. Whilst retail earnings growth is modest, TPW is reducing churn and the telco product is driving most of its retail earnings growth.

Earnings and cashflow outlook

- **Earnings growth modest and linked to margin growth:** TPW's future earnings growth is modest as it has no large-scale development projects planned in the near-term.
- **Operating cash flow strong but growth likely to be slow:** TPW has a strong track record of returning surplus cash to shareholders. Whilst there is unlikely to be strong ordinary dividend growth, we expect TPW to continue to pay fully imputed dividends.

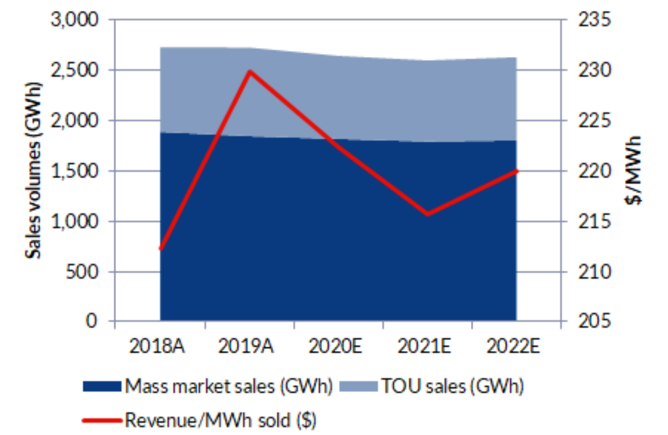
Financial structure

- **Balance sheet:** Following two substantial special dividends paid in FY19, balance sheet headroom is limited, although in our view the balance sheet is not stretched. TPW has no near-term material investments planned.

Risk factors

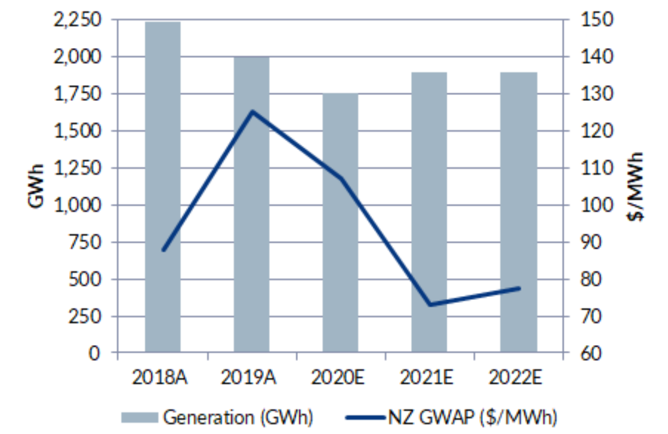
- **NZAS risk:** NZAS has indicated it is undertaking a strategic review, raising the possibility it may close. In our view, the smelter is unlikely to close (less than 10% chance) and TPW will be among the least affected if it does.
- **Rising bond yields:** In recent years TPW has traded in line with bond yields. A lift in interest rates is likely to see TPW trade lower, although in our view interest rates are likely to remain low for the foreseeable future.

Figure 4. Retail sales volumes and average price received



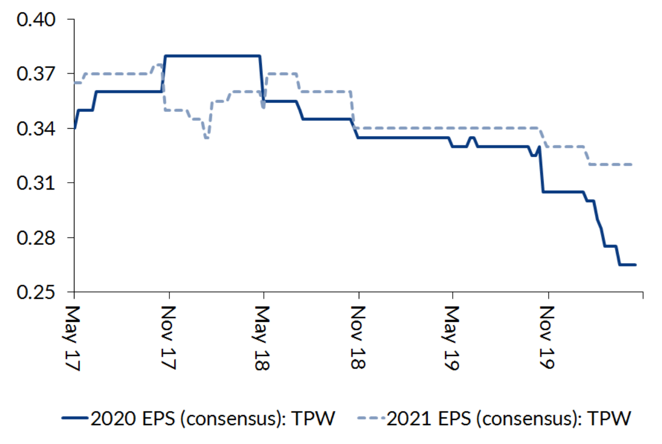
Source: TPW, Forsyth Barr analysis

Figure 5. Generation volumes and average price received



Source: TPW, Forsyth Barr analysis

Figure 6. Price performance



Source: Forsyth Barr analysis

Figure 7. Substantial shareholders

Shareholder	Latest Holding
Infratil	51.0%
TECT Holdings	26.8%

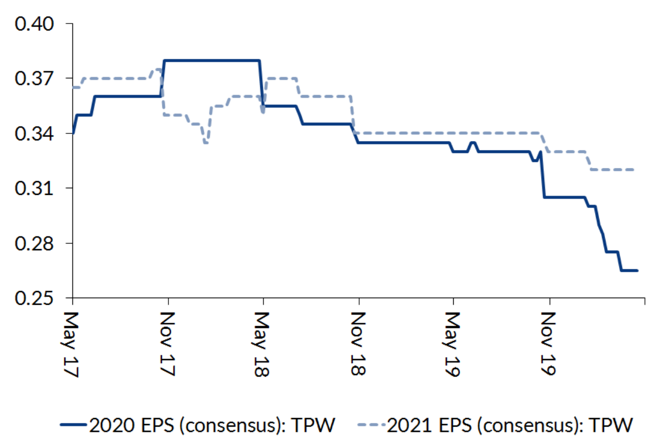
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 8. International valuation comparisons

Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash Yld
(metrics re-weighted to reflect TPW's balance date - March)			(m)	2020E	2021E	2020E	2021E	2020E	2021E	2021E
Trustpower	**TPW NZ**	**NZ$6.61**	**NZ$2,069**	**24.7x**	**21.3x**	**14.0x**	**12.9x**	**17.8x**	**16.1x**	**5.1%**
Contact Energy *	CEN NZ	NZ$6.30	NZ$4,524	19.1x	18.9x	12.1x	12.0x	23.3x	23.4x	6.2%
Genesis Energy *	GNE NZ	NZ$2.85	NZ$2,957	18.4x	16.0x	11.6x	10.7x	29.8x	26.5x	6.1%
Meridian Energy *	MEL NZ	NZ$4.82	NZ$12,354	24.8x	27.0x	16.0x	16.9x	24.7x	27.4x	4.5%
Mercury *	MCY NZ	NZ$4.59	NZ$6,246	26.9x	24.5x	14.8x	14.4x	25.2x	24.4x	3.5%
AGL ENERGY	AGL AT	A$17.09	A$10,752	13.0x	13.2x	6.5x	6.5x	9.9x	10.2x	5.7%
ORIGIN ENERGY	ORG AT	A$4.89	A$8,612	8.2x	15.5x	6.5x	6.1x	12.7x	18.0x	4.4%
			Compco Average:	**18.4x**	**19.2x**	**11.3x**	**11.1x**	**20.9x**	**21.6x**	**5.1%**
EV = Current Market Cap + Actual Net Debt			**TPW Relative:**	**34%**	**11%**	**25%**	**17%**	**-15%**	**-26%**	**2%**

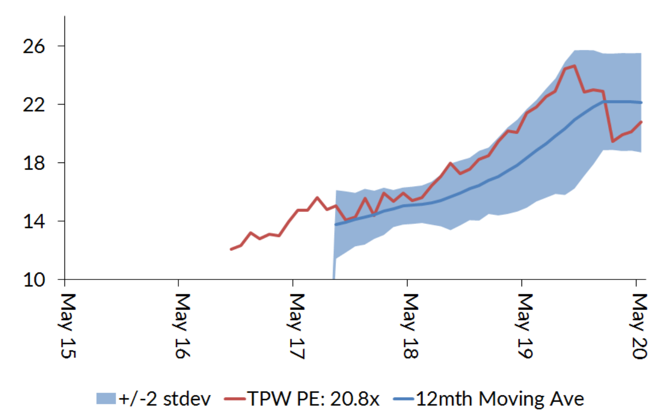
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (TPW) companies fiscal year end

Figure 9. Consensus EPS momentum (NZ$)



Source: Forsyth Barr analysis

Figure 10. One year forward PE (x)



Source: Forsyth Barr analysis

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OUTPERFORM	NEUTRAL	UNDERPERFORM
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