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NEW ZEALAND EQUITY RESEARCH | UTILITIES | ELECTRICITY GENERATOR/RETAILER
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# Trustpower
## No Fireworks Here — 1H21 Result Review


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## NEUTRAL

Trustpower's (TPW) headline 1H21 result contained no fireworks, which is a good thing for a generator/retailer. 1H21 EBITDAF of NZ$110m was +NZ$3m better than 1H20, a good result considering the challenging 1H21 hydro conditions. Continuing poor hydro conditions has caused TPW to lower its FY21 EBITDAF guidance mid-point -NZ$7.5m. The only minor surprise in the result was TPW's 17.0cps dividend, +1.5cps higher than the final FY20 dividend. Our -3.6% target price cut to NZ$7.50 is due to a softer than anticipated outlook for ACOT and higher maintenance capex. We retain our NEUTRAL rating.

| NZX Code | TPW |
|---|---|
| Share price | NZ$7.06 |
| Target price | NZ$7.50 |
| Risk rating | Low |
| Issued shares | 313.0m |
| Market cap | NZ$2,210m |
| Avg daily turnover | 46.1k (NZ$319k) |

| Financials: Mar/ | 20A | 21E | 22E | 23E |
|---|---|---|---|---|
| NPAT* (NZ$m) | 74.2 | 83.8 | 79.8 | 74.7 |
| EPS* (NZc) | 23.6 | 26.7 | 25.4 | 23.8 |
| EPS growth* (%) | -36.4 | 13.0 | -4.7 | -6.5 |
| DPS (NZc) | 32.5 | 32.0 | 30.0 | 30.0 |
| Imputation (%) | 100 | 100 | 100 | 100 |
| *Based on normalised profits | | | | |

| Valuation (x) | 20A | 21E | 22E | 23E |
|---|---|---|---|---|
| PE | 29.9 | 26.5 | 27.8 | 29.7 |
| EV/EBIT | 19.5 | 19.5 | 20.2 | 21.1 |
| EV/EBITDA | 15.1 | 14.9 | 15.2 | 15.7 |
| Price / NTA | 2.1 | 2.2 | 2.2 | 2.2 |
| Cash div yld (%) | 4.6 | 4.5 | 4.2 | 4.2 |
| Gross div yld (%) | 6.4 | 6.3 | 5.9 | 5.9 |

### What's changed?

- **Earnings:** FY21 EBITDAF trimmed -NZ$2m to NZ$192m. Compares to revised TPW EBITDAF guidance of NZ$185m to NZ$205m
- **Target price:** Lowered -28cps (-3.6%) to NZ$7.50/share
- **Rating:** NEUTRAL rating retained

### Earnings in line with expectations

The headline result contained no surprises. 1H21 EBITDAF of NZ$110m was just -NZ$1m below our forecast. Similarly 1H21 Normalised NPAT (after minorities) of NZ$52m was -NZ$1m below our forecast. The result was a good one compared to the 1H20 given the weak hydro conditions that prevailed during the period. Lifting the result vs. 1H20 was lower customer acquisition costs, an improved telco gross profit, and higher electricity retail margins.

### Interim dividend better than expected, as is FY dividend signal, but appears above the top end of the dividend policy

The only real surprise in the result was TPW maintaining its fully imputed interim dividend of 17.0cps. We had assumed TPW would drop the dividend -1.5cps, consistent with the FY20 final dividend. Indications are, assuming 2H21 and the FY22 outlook is reasonable, TPW is likely to lift its final FY21 dividend back to 17.0cps. If TPW pays a 34cps FY21 dividend, we estimate it will be an FY21 free cash flow payout ratio of ~108%, comfortably above the top end of its 90% policy range. Given TPW's sector high gearing level, we believe its dividend is more susceptible to a decline in earnings (for example from NZAS closing) than other electricity stocks.

### Minor FY21 forecast changes, a couple of issues to be wary of medium-term

TPW has lowered its FY21 EBITDAF guidance range to between NZ$185m and NZ$205m. Previously it was NZ$190m to NZ$215m. The main issue is continued low hydro conditions. We have trimmed our FY21 EBITDAF forecast -NZ$2m to NZ$192m, slightly below the mid-point of the range. Medium-term forecast changes are greater, with avoided cost of transmission (ACOT) revenue reduced ~-NZ$5m following a lower than expected 1H21 contribution. In addition, TPW maintenance capex guidance was higher than expected. The -3.6% cut to our target price (-28cps to NZ$7.50) primarily reflects lower ACOT revenue and increased maintenance capex.

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# Trustpower Ltd (TPW)

| | |
|---|---|
| Priced as at 05 Nov 2020 (NZ$) | **7.06** |

| **12-month target price (NZ$)*** | **7.50** |
|---|---|
| Expected share price return | 6.2% |
| Net dividend yield | 4.3% |
| Estimated 12-month return | 10.6% |

| **Spot valuations (NZ$)** | |
|---|---|
| 1. DCF | 7.06 |
| 2. Market multiples | 6.95 |
| 3. Dividend Yield | 7.32 |

| **Key WACC assumptions** | |
|---|---|
| Risk free rate | 1.30% |
| Equity beta | 0.84 |
| WACC | 5.4% |
| Terminal growth | 1.5% |

| **DCF valuation summary (NZ$m)** | |
|---|---|
| Total firm value | 2,887 |
| (Net debt)/cash | (662) |
| Less: Capitalised operating leases | |
| Value of equity | 2,209 |

| **Profit and Loss Account (NZ$m)** | **2019A** | **2020A** | **2021E** | **2022E** | **2023E** |
|---|---|---|---|---|---|
| Sales revenue | 1,030.1 | 989.9 | 926.9 | 880.3 | 859.0 |
| **Normalised EBITDA** | **222.2** | **186.5** | **192.4** | **189.8** | **183.9** |
| Depreciation and amortisation | (47.2) | (42.6) | (45.1) | (46.4) | (46.6) |
| **Normalised EBIT** | **175** | **144** | **147** | **143** | **137** |
| Net interest | (28) | (32) | (30) | (29) | (29) |
| Depreciation capex adjustment | 19 | (2) | 3 | 0 | (0) |
| Tax | (45) | (32) | (34) | (32) | (30) |
| Minority interests | (2) | (3) | (2) | (3) | (3) |
| **Normalised NPAT** | **117** | **74** | **84** | **80** | **75** |
| Abnormals/other/depn adj | (26) | 21 | (21) | (0) | 0 |
| **Reported NPAT** | **91** | **95** | **63** | **80** | **75** |
| Normalised EPS (cps) | 37.1 | 23.6 | 26.7 | 25.4 | 23.8 |
| DPS (cps) | 74.0 | 32.5 | 32.0 | 30.0 | 30.0 |

| **Valuation Ratios** | **2019A** | **2020A** | **2021E** | **2022E** | **2023E** |
|---|---|---|---|---|---|
| EV/EBITDA (x) | 12.3 | 15.1 | 14.9 | 15.2 | 15.7 |
| EV/EBIT (x) | 15.6 | 19.5 | 19.5 | 20.2 | 21.1 |
| PE (x) | 19.0 | 29.9 | 26.5 | 27.8 | 29.7 |
| Price/NTA (x) | 1.9 | 2.1 | 2.2 | 2.2 | 2.2 |
| Free cash flow yield (%) | 4.0 | 3.5 | 4.3 | 3.8 | 3.8 |
| Net dividend yield (%) | 10.5 | 4.6 | 4.5 | 4.2 | 4.2 |
| Gross dividend yield (%) | 12.7 | 6.4 | 6.3 | 5.9 | 5.9 |

| **Capital Structure** | **2019A** | **2020A** | **2021E** | **2022E** | **2023E** |
|---|---|---|---|---|---|
| Interest cover EBIT (x) | 6.8 | 4.9 | 5.3 | 5.4 | 5.2 |
| Interest cover EBITDA (x) | 7.9 | 5.9 | 6.4 | 6.6 | 6.3 |
| Net debt/ND+E (%) | 58.6 | 64.8 | 69.2 | 70.8 | 72.7 |
| Net debt/EBITDA (x) | 2.5 | 3.3 | 3.5 | 3.6 | 3.8 |

| **Growth Rates** | **2019A** | **2020A** | **2021A** | **2022A** | **2023A** |
|---|---|---|---|---|---|
| Revenue (%) | 5.2 | -3.9 | -6.4 | -5.0 | -2.4 |
| EBITDA (%) | -17.6 | -16.1 | 3.2 | -1.4 | -3.1 |
| EBIT (%) | -21.6 | -17.8 | 2.4 | -2.7 | -4.2 |
| Normalised NPAT (%) | -17.3 | -36.4 | 13.0 | -4.7 | -6.5 |
| Normalised EPS (%) | -17.3 | -36.4 | 13.0 | -4.7 | -6.5 |
| Ordinary DPS (%) | 0.0 | -4.4 | -1.5 | -6.3 | 0.0 |

| **Key Ratios** | **2019A** | **2020A** | **2021E** | **2022E** | **2023E** |
|---|---|---|---|---|---|
| Return on assets (%) | 7.2 | 8.0 | 5.6 | 6.7 | 6.4 |
| Return on equity (%) | 9.7 | 6.9 | 8.1 | 7.9 | 7.5 |
| Return on funds employed (%) | 7.2 | 5.6 | 6.5 | 5.9 | 5.6 |
| EBITDA margin (%) | 21.6 | 18.8 | 20.8 | 21.6 | 21.4 |
| EBIT margin (%) | 17.0 | 14.5 | 15.9 | 16.3 | 16.0 |
| Capex to sales (%) | 3.0 | 4.5 | 3.8 | 4.4 | 4.6 |
| Capex to depreciation (%) | 98 | 142 | 107 | 119 | 120 |
| Imputation (%) | 55 | 100 | 100 | 100 | 100 |
| Pay-out ratio (%) | 199 | 138 | 120 | 118 | 126 |

| **Cash Flow (NZ$m)** | **2019A** | **2020A** | **2021E** | **2022E** | **2023E** |
|---|---|---|---|---|---|
| **EBITDA** | **222.2** | **186.5** | **192.4** | **189.8** | **183.9** |
| Working capital change | (47.1) | 1.7 | (16.3) | (8.0) | (3.6) |
| Interest & tax paid | (74.8) | (77.1) | (69.9) | (59.2) | (58.2) |
| Other | 20.0 | 10.9 | 23.2 | 1.3 | 1.3 |
| **Operating cash flow** | **120.3** | **121.9** | **129.5** | **123.9** | **123.3** |
| Capital expenditure | (31.1) | (44.7) | (34.8) | (39.0) | (39.7) |
| (Acquisitions)/divestments | 8.1 | 20.2 | 0 | 0 | 0 |
| Other | 0 | (6.8) | (8.7) | (8.7) | (8.7) |
| **Funding available/(required)** | **97.3** | **90.6** | **86.0** | **76.2** | **74.9** |
| Dividends paid | (190.4) | (156.7) | (103.4) | (93.9) | (93.9) |
| Equity raised/(returned) | (1) | (1) | 0 | 0 | 0 |
| **(Increase)/decrease in net debt** | **(94.5)** | **(67.4)** | **(17.4)** | **(17.7)** | **(19.0)** |

| **Operating Performance** | **2019A** | **2020A** | **2021E** | **2022E** | **2023E** |
|---|---|---|---|---|---|
| NZ electricity revenue | 861 | 804 | 746 | 694 | 665 |
| Gas revenue | 29 | 30 | 31 | 32 | 34 |
| Telecommunication revenue | 88 | 98 | 99 | 102 | 108 |
| Other revenue | 52 | 58 | 51 | 52 | 53 |
| **Total revenue** | **1,030** | **990** | **927** | **880** | **859** |
| | | | | | |
| Generation (GWh) | 1,995 | 1,758 | 1,702 | 1,918 | 1,939 |
| NZ GWAP ($/MWh) | 125 | 107 | 121 | 76 | 61 |
| | | | | | |
| Mass market sales (GWh) | 1,845 | 1,817 | 1,834 | 1,788 | 1,773 |
| TOU sales (GWh) | 880 | 826 | 536 | 587 | 590 |
| Spot sales (GWh) | 1,021 | 972 | 866 | 933 | 937 |
| **Total Sales (GWh)** | **3,746** | **3,615** | **3,235** | **3,308** | **3,300** |
| LWAP ($/MWh) | 131 | 109 | 122 | 78 | 64 |
| LWAP/GWAP | 1.04 | 1.02 | 1.01 | 1.03 | 1.04 |
| | | | | | |
| Electricity customers (000) | 267 | 266 | 262 | 259 | 256 |
| Usage/customer (MWh) | 6.8 | 6.8 | 7.0 | 6.9 | 6.9 |
| Revenue/MWh sold ($) | 230 | 222 | 231 | 210 | 201 |
| Gas customers (000) | 39 | 41 | 43 | 43 | 44 |
| Volume/customer (GJ) | 26.5 | 24.9 | 25.9 | 25.9 | 25.9 |
| Telco customers (000) | 96 | 104 | 109 | 113 | 116 |
| Revenue/customer ($) | 963 | 983 | 978 | 988 | 998 |

| **Balance Sheet (NZ$m)** | **2019A** | **2020A** | **2021E** | **2022E** | **2023E** |
|---|---|---|---|---|---|
| Working capital | (0.3) | (8.2) | 26.3 | 28.4 | 27.1 |
| Fixed assets | 1,924.7 | 1,836.4 | 1,835.6 | 1,835.7 | 1,835.9 |
| Intangibles | 37.0 | 38.7 | 37.8 | 37.6 | 37.9 |
| Right of use asset | 0 | 35.5 | 37.1 | 37.1 | 37.1 |
| Other assets | 114.8 | 100.2 | 111.2 | 117.0 | 122.0 |
| **Total funds employed** | **2,076.2** | **2,002.6** | **2,048.0** | **2,055.9** | **2,060.0** |
| Net debt/(cash) | 557.4 | 616.7 | 665.5 | 683.2 | 702.1 |
| Lease liability | 0 | 36.1 | 38.2 | 38.2 | 38.2 |
| Other liabilities | 269.8 | 249.8 | 270.0 | 271.9 | 273.4 |
| Shareholder's funds | 1,224.4 | 1,076.2 | 1,049.5 | 1,035.4 | 1,016.5 |
| Minority interests | 24.6 | 23.8 | 24.7 | 27.2 | 29.8 |
| **Total funding sources** | **2,076.2** | **2,002.6** | **2,048.0** | **2,055.9** | **2,060.0** |

## Dividend appears to be higher than stated dividend policy, making dividend susceptible to a permanent dip in earnings

TPW's interim dividend of 17.0cps was +1.5cps ahead of our forecast and is the main headline surprise. We had assumed that TPW would match the final FY20 dividend of 15.5cps, particularly given the weak hydro conditions (and therefore below average 1H result), below average 2H21 outlook and TPW's high gearing (above 3.0x net debt to EBITDA). That prompted us to have a look at TPW's dividend relative to its policy.

Our analysis highlights that a 34cps dividend is possible if TPW is paying out ~100% of free cash flow from average hydro earnings. However, we estimate that average hydrology earnings are above the top of TPW's FY21 guidance range. In addition, even using average hydro earnings, TPW is paying more than its stated 70% to 90% free cash flow dividend policy.

The main take-out from this analysis is that whilst TPW can pay 100% of free cash flow, its dividend is susceptible to a drop in earnings (for example, from NZAS closing), in part due to high gearing levels.

**Figure 1. Dividend analysis**

| | Low NZ$m | Mid NZ$m | High NZ$m | Comment |
|---|---|---|---|---|
| **Average hydro EBITDAF** | **195.0** | **207.5** | **220.0** | Slightly higher than FY21 guidance to account for below average generation and COVID-19 conservatism |
| Capex | (32.0) | (30.0) | (28.0) | FY21 maintenance capex guidance is $29m to NZ$37m, but is elevated by Waipori work |
| Interest | (28.0) | (25.5) | (23.0) | Excludes lease interest expense |
| Tax | (35.8) | (40.3) | (44.8) | |
| Minority interest | (3.0) | (2.5) | (2.0) | |
| **Free cash flow proxy** | **96.2** | **109.2** | **122.2** | |
| FCF (NZ cps) | 30.7 | 34.9 | 39.0 | Average hydrology earnings supports 34cps, just |
| | | | | |
| Dividend policy payout ratio | 90% | 80% | 70% | TPW stated policy is to pay between 70% and 90% of free cash flow |
| Dividend (NZ$m) | 86.6 | 87.4 | 85.6 | |
| Dividend (NZ cps) | 27.7 | 27.9 | 27.3 | Dividend per policy should be 27 to 28cps |

Source: Forsyth Barr analysis

## Summary forecast changes

**Figure 2. Summary forecast changes**

| | FY21 Old $m | FY21 New $m | Chg % | FY22 Old $m | FY22 New $m | Chg % | FY23 Old $m | FY23 New $m | Chg % |
|---|---|---|---|---|---|---|---|---|---|
| Revenue | 928 | 927 | -0.1% | 893 | 880 | -1.4% | 877 | 859 | -2.0% |
| **EBITDAF** | **194** | **192** | **-1.0%** | **194** | **190** | **-2.0%** | **187** | **184** | **-1.8%** |
| EBIT | 147 | 147 | 0.0% | 147 | 143 | -2.2% | 140 | 137 | -2.0% |
| NPAT | 87 | 65 | -25.1% | 87 | 82 | -5.6% | 83 | 78 | -6.2% |
| Normalised Profit | 84 | 82 | -3.1% | 85 | 80 | -5.6% | 80 | 75 | -6.2% |
| DPS | 30.5 | 32.0 | 4.9% | 30.0 | 30.0 | 0.0% | 30.0 | 30.0 | 0.0% |
| | | | | | | | | | |
| Generation volumes (GWh) | 1,771 | 1,702 | -3.9% | 1,896 | 1,918 | 1.1% | 1,896 | 1,939 | 2.2% |
| Generation sales price ($/MWh) | $122.5 | $120.8 | -1.4% | $74.0 | $75.9 | 2.5% | $61.5 | $61.5 | 0.0% |
| Retail sales (GWh) | 2,369 | 2,369 | 0.0% | 2,375 | 2,375 | 0.0% | 2,363 | 2,363 | 0.0% |

Source: Forsyth Barr analysis

Our TPW forecast continues to assume NZAS closes on 31 August 2021 (consistent with our other electricity forecasts). We address the upside from NZAS remaining open in our target price.

Key forecast changes:

- Lower ACOT revenue with 1H21 ACOT revenue -NZ$2.6m lower than 1H20.
- Higher FY21 telco contribution (+NZ$2.5m) due to better than expected 1H21 earnings.
- Reduced FY21 generation volumes -3.9%, but increased later years as generation enhancement projects come to fruition.
- Increased capex outlook following TPW guidance update, +NZ$4m higher in FY21 and +NZ$7m higher in FY22 and FY23. Our long-term capex forecast has increased +NZ$2.5m to NZ$32.5m.
- FY21 dividend forecast increased +1.5cps to 32cps. Our final FY21 dividend of 15.0cps assumes NZAS has announced it is closing.

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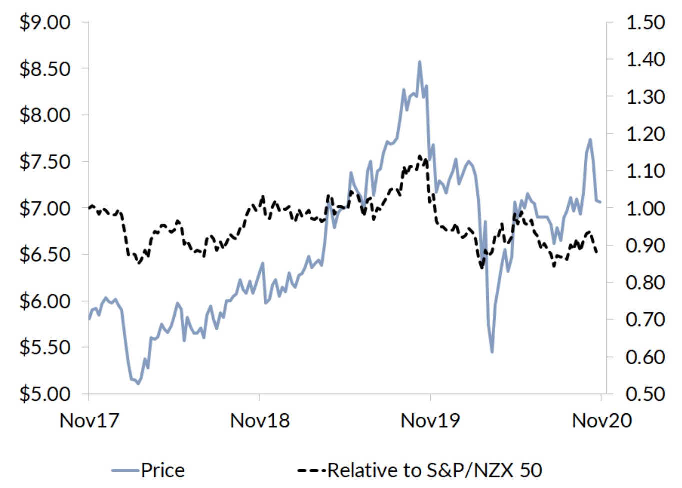
## Summary result analysis

### Figure 3. 1H21 result summary

| 6 Mths Ending Sept (NZ$m) | 1H20 | 1H21 | Change | FB | Diff | Commentary |
|---|---|---|---|---|---|---|
| Electricity | 448 | 416 | -7% | 407 | 9 | Decline mainly due to lower sales volumes, but also lower wholesale price |
| Other | 92 | 90 | -1% | 91 | (1) | |
| **Total Revenue** | 539 | 506 | -6% | 498 | 8 | |
| Costs | (432) | (396) | -8% | (387) | (9) | Lower opex vs. 1H20 due to lower sales volumes |
| **EBITDAF** | 107 | 110 | 3% | 111 | (1) | Slight increase on 1H20 — good result in light of softer generation volumes |
| Depreciation and amortisation | (20) | (22) | 11% | (24) | 2 | Inclusion of lease depreciation leads to increase in depreciation |
| **EBIT** | 87 | 88 | 1% | 87 | 1 | |
| Fair value gains/(losses) | (12) | (26) | | 0 | (26) | We do not forecast fair value movements |
| One-off items | (2) | 0 | | 0 | 0 | |
| Net interest | (17) | (15) | -11% | (13) | (2) | Decline due to lower interest rates |
| **Pretax Profit** | 56 | 47 | -16% | 74 | (27) | |
| Tax | (17) | (13) | -22% | (21) | 8 | |
| **Reported Profit** | 39 | 34 | -13% | 53 | (20) | |
| Minority interests | (1) | (0) | | (1) | | |
| **Profit Attributable to Shareholders** | 38 | 33 | -13% | 53 | (20) | |
| Abnormal items | 11 | 19 | | 0 | 19 | Abnormal is after-tax fair value adjustment |
| **Normalised Profit** | 49 | 52 | 7% | 53 | (1) | |
| Earnings per share (cps) | 15.5 | 16.7 | 7% | 16.9 | (0.2) | |
| Dividend per share (cps) | 17.0 | 17.0 | 0% | 15.5 | 1.5 | 1H21 dividend consistent with 1H20, but up on 2H20 final dividend |
| | | | | | | |
| NZ generation (GWh) | 989 | 945 | -4% | 945 | 0 | |
| FPVV electricity sold (GWh) | 1,443 | 1,301 | -10% | 1,301 | 0 | Big drop in time of use sales due to loss of high volume, low margin customer |

Source: TPW, Forsyth Barr analysis

### Figure 4. Price performance




Source: Forsyth Barr analysis

### Figure 5. Substantial shareholders

| Shareholder | Latest Holding |
|---|---|
| Infratil | 51.0% |
| TECT Holdings | 26.8% |

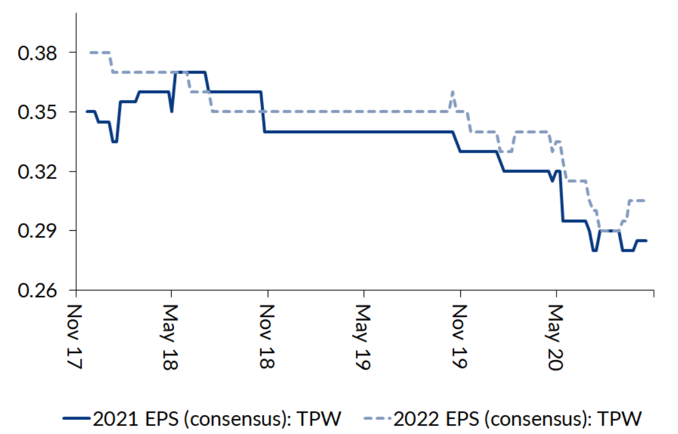
Source: NZX, Forsyth Barr analysis, NOTE: based on SPH notices only

### Figure 6. 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) | 2021E | 2022E | 2021E | 2022E | 2021E | 2022E | 2022E |
| **Trustpower** | **TPW NZ** | **NZ$7.06** | **NZ$2,210** | **26.5x** | **27.8x** | **14.7x** | **14.9x** | **19.2x** | **19.7x** | **4.2%** |
| CONTACT ENERGY * | CEN NZ | NZ$7.53 | NZ$5,411 | 21.8x | 25.7x | 14.0x | 15.7x | 30.0x | 36.4x | 4.2% |
| GENESIS ENERGY * | GNE NZ | NZ$3.06 | NZ$3,193 | 17.9x | 16.9x | 11.4x | 11.7x | 25.3x | 27.8x | 4.6% |
| MERIDIAN ENERGY * | MEL NZ | NZ$5.50 | NZ$14,081 | 31.3x | 35.7x | 20.2x | 22.8x | 33.6x | 41.0x | 3.1% |
| MERCURY * | MCY NZ | NZ$5.32 | NZ$7,247 | 28.3x | 28.9x | 17.0x | 16.9x | 30.1x | 31.2x | 3.2% |
| AGL ENERGY | AGL AT | A$12.90 | A$8,037 | 11.8x | 15.4x | 5.7x | 6.5x | 9.5x | 12.1x | 6.4% |
| ORIGIN ENERGY | ORG AT | A$4.28 | A$7,538 | 38.4x | 14.9x | 22.2x | 5.1x | 6.1x | 16.4x | 5.3% |
| | | | **Compco Average:** | **24.9x** | **22.9x** | **15.1x** | **13.1x** | **22.4x** | **27.5x** | **4.5%** |
| EV = Current Market Cap + Actual Net Debt | | | **TPW Relative:** | **6%** | **21%** | **-3%** | **14%** | **-14%** | **-28%** | **-5%** |

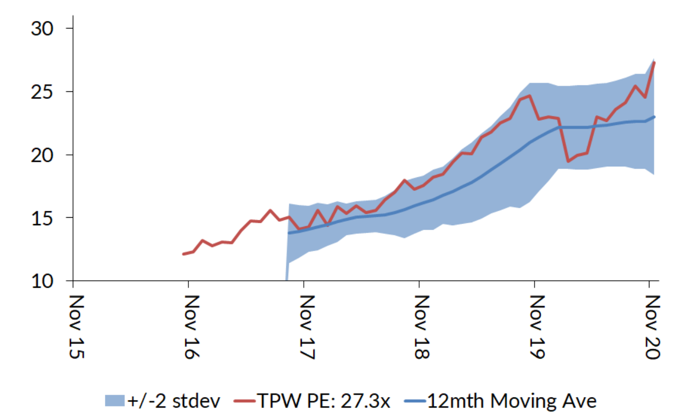
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (TPW) companies fiscal year end

### Figure 7. Consensus EPS momentum (NZ$)




Source: Forsyth Barr analysis

### Figure 8. One year forward PE (x)




Source: Forsyth Barr analysis

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| 37.7% | 47.2% | 15.1% |

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